

NOTE

This Microfiche meets the quality requirements of the American National Standard for Microfiche of Documents (ANSI PH5.9-1975). However, because of imperfections in the document from which it was made, it contains images that are illegible or difficult to read. The source document for this microfiche is the best copy that could be obtained prior to filming.

Congressional Information Service, Inc.
4520 East-West Highway
Bethesda, Maryland 20814



THE 1991 JOINT ECONOMIC REPORT

REPORT

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ON THE

1991 ECONOMIC REPORT
OF THE PRESIDENT

together with

MINORITY AND ADDITIONAL VIEWS



MARCH 22 (legislative day, FEBRUARY 6), 1991.—Ordered to be printed

U.S. GOVERNMENT PRINTING OFFICE

41-238

WASHINGTON : 1991

J843-1

JOINT ECONOMIC COMMITTEE

(Created pursuant to Sec. 5(a) of Public Law 304, 79th Cong.)

102d CONGRESS

SENATE

PAUL S. SARBANES, *Maryland*,
Chairman
LLOYD BENTSEN, *Texas*
EDWARD M. KENNEDY, *Massachusetts*
JEFF BINGAMAN, *New Mexico*
ALBERT GORE, JR., *Tennessee*
RICHARD H. BRYAN, *Nevada*
WILLIAM V. ROTH, JR., *Delaware*
STEVE SYMMS, *Idaho*
CONNIE MACK, *Florida*
ROBERT C. SMITH, *New Hampshire*

HOUSE OF REPRESENTATIVES

LEE H. HAMILTON, *Indiana*,
Vice Chairman
DAVID R. OBEY, *Wisconsin*
JAMES H. SCHEUER, *New York*
FORTNEY H. (PETE) STARK, *California*
STEPHEN J. SOLARZ, *New York*
KWEISI MFUME, *Maryland*
RICHARD K. ARMEY, *Texas*
CHALMERS P. WYLIE, *Ohio*
OLYMPIA J. SNOWE, *Maine*
HAMILTON FISH, Jr., *New York*

Stephen Quick, *Executive Director*
Richard F Kaufman, *General Counsel*
Edward Gillespie, *Minority Staff Director*

(II)

LETTER OF TRANSMITTAL

March 21, 1991.

Hon. George J. Mitchell,
Majority Leader, U.S. Senate,
Washington, D.C.

Dear Mr. Leader: Pursuant to the requirements of the Employment Act of 1946, as amended, I hereby transmit the 1991 Joint Economic Report. The analyses and conclusions of this Report are to assist the several Committees of the Congress and its Members as they deal with economic issues and legislation pertaining thereto.

Sincerely,

Paul S. Sarbanes, *Chairman.*

(III)



CONTENTS

	<i>Page</i>
I INTRODUCTION	1
II ROOTS OF THE RECESSION	7
Long-Term Deterioration	7
Short-Term Shocks	14
III RECESSION: THE CASE FOR CONCERN	17
1. The Consensus Is Usually Biased Toward Optimism	17
2. Consumer Spending May Remain Subdued	19
3. Export Growth May Stall	21
4. Debt Levels and Financial Fragility	24
IV RESPONDING TO THE RECESSION	27
Monetary Policy	27
Inflation and the Dollar	28
The Supply of Credit: "The Credit Crunch"	29
The Demand for Credit	31
Fiscal Policy: Automatic Stabilizers	32
Unemployment Insurance	32
State and Local Finance: The Automatic Destabilizers	36
Fiscal Policy: Discretionary Stabilizers	38
War and Reconstruction	39
Additional Discretionary Changes in Fiscal Policy	41
V BEYOND THE RECESSION: LONG-TERM TREND IN THE U.S. ECONOMY	45
Productivity Growth And The Standard Of Living	45
Assets: The Key To Productivity Growth	47
Physical Capital	49
Research and Development	51
Human Capital	54

	<i>Page</i>
VI PUBLIC SUPPORT FOR ASSET-CREATION	59
Direct Investment in Infrastructure	59
Investing In People	65
Investing In Ideas: Science and Technology Policy	67
Investing In Information: The Public Statistical System	70
Budgeting for Investment	73
VII CREATING AN INTERNATIONAL CONTEXT	
FOR GROWTH	79
Growth-Oriented Macroeconomic Policy	79
Financing Reform In The Middle-Income Countries	81
Sharing The Benefits Of Expanded Trade	84
Sharing The Burdens Of Leadership	87
The Defense Burden	88
The Development Burden	89

MINORITY VIEWS

	<i>Page</i>
I RESTORING ECONOMIC GROWTH	95
Economic Review And Outlook	95
Restructuring of American Industry	98
Economic Outlook	99
Policies for Economic Growth	99
II THE TURNAROUND IN FAMILY INCOME: A REVIEW OF THE 1980S	101
The Fall and Rise of the Middle Class	103
The Level of Family and Household Income	106
Alternative Family Income Measures ^a	109
Average Family Income by Quintile	109
Income and Public Policy	110
Measuring Income	111
III THE FEDERAL INCOME TAX BURDEN (1981-88)	114
Tax Rates	117
Fairness Ratio	119
IV THE FEDERAL BUDGET	121
Budget Outlook	123
New Rules are Needed	124
Realism and Government Policy	125
V PRINCIPLES OF A MORE THOUGHTFUL DOMESTIC POLICY	127
VI MONETARY POLICY	135
VII BANKING, INTERNATIONAL FINANCE, AND DOMESTIC GROWTH	140
VIII INTERNATIONAL ECONOMICS -- AT THE CROSSROADS .	147
The Current Outlook	147
The General Agreement on Tariffs and Trade (GATT), the Uruguay Round and the Future of the Trading System	148
Free Trade Areas and U.S. Exports	151
The U.S.-Canada Free Trade Agreement and Future	

Agreements	152
------------------	-----

*Page***VIII (Continued)**

Free Trade Areas and Agricultural Trade	153
Free Trade Agreements with Mexico and the Americas	154
International Trade in Advanced Technology and Services	157
IX A NEW WORLD: ORDER OR DISORDER?	159
A World of Trading Blocs?	160
Western Hemisphere	161
Europe	161
The Pacific Rim	162
Eastern and Central Europe	162
The Soviet Disunion: Political and Economic Instability in the USSR	166
A New Strategy for Foreign Aid	170
X NATIONAL SECURITY AND THE DEFENSE BUDGET	175
U.S. Strategic Interests in the Post-Cold War Environment	176
Understanding 1990s' Threats to U.S. Interests	177
The Current Soviet Threat	178
Non-Soviet Threats and the Rise of the Global Arms Industry	178
Alternative Means of Responding to Threats	180
Treaties	180
Police Actions/Show of Force	180
Unilateral Sanctions and Multilateral Controls	181
Security Through Shared Trade Partnerships	182
Efficiently Spending Defense Resources: Recommendations	182
National Security Expenditures in the 1990s	186
XI CONCLUSION	188

Additional Views

Representative Olympia J. Snowe	194
---------------------------------------	-----

THE 1991 JOINT ECONOMIC REPORT ON THE 1991
ECONOMIC REPORT OF THE PRESIDENT

MARCH 22 (legislative day, FEBRUARY 6), 1991.—Ordered to be printed

Mr. SARBANES, from the Joint Economic Committee,
submitted the following

REPORT

together with

MINORITY AND ADDITIONAL VIEWS

INTRODUCTION

The American economy slipped into recession around the middle of 1990. Current estimates are that the recession began in July of last year, somewhat ahead of the invasion of Kuwait. The Gulf crisis clearly added further downward pressure on an already weakened economy through high and uncertain oil prices and falling consumer confidence.

Although the Gulf crisis helped worsen the downturn, it did not cause it. The 1990 recession evolved slowly over the preceding several quarters, as a tight monetary policy from the Federal Reserve interacted with an economy beset by long-term structural problems. These structural problems are most visible in the financial sector, where the 1980s climate of speculation and inadequate supervision have created the largest financial crisis since the Great Depression.

But the structural problems of the American economy are visible elsewhere as well. Productivity fell in both 1989 and 1990, the first back-to-back decline in this critical indicator since the early 1970s. Real wages have fallen steadily since the fourth quarter of 1986, forcing families to work longer hours or put more family members into the work force.

Fewer resources are being set aside for building the productive capacity of our economy. The pace of asset creation, whether measured by private fixed investment, private research and development expenditures, or public investment activity has slowed to levels that raise concern about how well we can grow and compete in the future.

These structural problems have clearly contributed to the slowing of overall growth in the U.S. economy, but they have also contributed to a steady worsening in the distribution of income. By every available indicator, the 1980s witnessed a significant rise in the share of income going to the rich, at the expense of both the poor and the middle class.

Although growing income inequality largely reflects changes in the private economy, tax and expenditure policies at the federal level have largely pushed in the same direction. Programs providing benefits to families at the lower end of the income distribution have been cut severely, while

families at the upper end have benefited from huge reductions in their tax rates.

Those who point to the rising share of federal taxes paid by the rich conveniently fail to note that the share of income going to the rich has gone up even more than their share of taxes. Meanwhile, middle and lower income families have seen their share of both income and taxes fall, but their share of income has fallen more than their share of taxes. Thus, those with a greater ability to pay have enjoyed a decline in their tax burden, while those with less ability to pay are bearing a heavier burden. The 1990 tax changes began to redress some of the imbalances that have accumulated over the previous decade.

The Committee has been concerned about many of these long-term trends for several years, and has made an effort to draw attention to them in previous reports. Huge debt levels have clearly played a role in exacerbating today's much-discussed "credit crunch." The slowing of productivity growth is the principal explanation for the wage stagnation that has helped undermine consumer spending. And the sharp falloff in federal support for infrastructure has played a key role in the deteriorating fiscal position of state and local governments.

The current situation provides two basic challenges to economic policy. First, we must develop effective strategies to counteract the current cyclical downturn. This task calls for some creative thinking, since many of the traditional tools of countercyclical policy may be inappropriate in the current context. Second, we must craft new ways to address the more fundamental structural problems in the economy. We need to implement a broad new set of policies designed to get productivity growing again, ideally at rates close to those which prevailed earlier in the post-war period.

The Committee believes that accomplishing these two tasks--short term stabilization and rebuilding the foundations for long-term growth--will require a substantial reorientation in the way the country thinks about the economy, and the interaction between government and the private sector. Over the short term, we believe that several changes in economic policy are needed to help the economy emerge from recession:

- We believe that the Federal Reserve has kept monetary policy too tight for too long. Current economic conditions justify substantially lower interest rates than those currently prevailing.
- We believe that inadequate funding for the administrative costs of unemployment insurance is hindering the payment of benefits due to workers. We believe administrative costs should be allowed to rise as the number of claims rises.

- We believe that additional changes in the unemployment insurance system are needed to meet the humanitarian and countercyclical objectives of this program. The triggers for extending benefits in a recession may need to be recalibrated, so that no state would have to reach near-depression levels of unemployment before reaching the trigger.
- We believe additional countercyclical benefits could be obtained by "front loading" infrastructure spending projects already contained in the budget. Releasing funds early in the fiscal year instead of late would not alter budget agreements, but could provide a helpful boost for local economies struggling with recession.

Over the longer term, we believe that all economic actors--households, firms and governments--need to place more emphasis on adding to the stock of machinery, equipment, structures, knowledge and human skills, which can make the economy grow more rapidly and more equitably in the future.

We can divide these longer term recommendations into three broad categories. First, we believe the Federal Government needs to give asset-creating activity a higher priority in its own spending. To promote this objective:

- We believe it is time to re-examine the practice of accumulating reserves in trust funds earmarked for infrastructure finance. This practice both disguises the true nature of the federal deficit and prevents the Federal Government from providing much-needed support for infrastructure.
- Over the longer term, we believe consideration should be given to the development of a separate public corporation, similar to FNMA, to facilitate the flow of investment funding to state and local infrastructure projects.
- We believe it is important to reorient the Federal Government's annual spending on research and development toward investing more in developing basic commercial technologies.
- We support a broad range of new federal initiatives to focus attention and resources on improving American education. These include a substantial expansion of Head Start, new programs for the assessment and promotion of excellence among both teachers and students, dropout prevention and adult literacy efforts, and the creation of a nationwide apprenticeship program.

Second, the Federal Government should take the lead in pointing out the Nation's performance in creating productive assets. Current methods of budgetary and national income accounting do not appear to provide adequate information to monitor and promote investment activity. To promote better accounting for investment, we believe it is time to consider:

- Constructing a separate capital budget for the Federal Government, to focus attention on the investment activities undertaken at the federal level.
- Moving toward the adoption of the U.N. System of National Accounts, a system of national income accounting that would allow better tracking of investment activities by both the public and private sectors.

Finally, we recognize that the American economy cannot ignore economic events elsewhere in the world. Our prosperity is intimately tied to the prosperity of other countries. In such a world, economic diplomacy must share with domestic fiscal and monetary policy the task of promoting American economic growth.

We must ensure that the world economy continues to grow, and that market opportunities for American producers are maintained in this growing world economy. To promote this objective:

- We urge the monetary authorities in both Germany and Japan to move interest rates lower in the coming months. Continued tight money policies in these countries runs serious risks of contributing to a global recession.
- We recommend that U.S. trade negotiators focus their efforts on barriers to U.S. exports in major industrialized economies, particularly Japan.
- We endorse the strategy of debt reduction for those middle-income countries that have been pursuing policies of economic reform, but believe there remains a financing problem for these countries, which will require additional capital flows from both public and private sources if the pace of reform is to be sustained.
- We believe that current arrangements for sharing the burdens of leadership in the world economy need to be re-examined. Despite ad-hoc, crisis-oriented solutions, the United States continues to bear a disproportionate share of the burden of maintaining a peaceful world, while other major nations use their resources disproportionately for commercial gain.

The remainder of this Report is divided into six chapters. Chapter II discusses the roots of the current recession, focusing on both long-term deterioration and the short-term shocks that have helped drive the country into recession. Chapter III discusses the factors in the current economic situation that create the greatest concern. Chapter IV discusses in detail the kind of policy response we believe is needed under current conditions. Chapter V attempts to look beyond the recession to assess the longer term needs of the country. It draws attention particularly to the inadequate pace of asset creation in the American economy. Chapter VI explores public policies that can help improve the pace of asset creation in the economy. Finally, Chapter VII looks at the kinds of international economic policies that are needed to support domestic growth.

ROOTS OF THE RECESSION

The current recession apparently started around the middle of 1990, somewhat before the invasion of Kuwait. The invasion contributed to the economy's problems through both rising oil prices and falling consumer confidence, but the situation in the Gulf was not the principal cause of the recession.

The U.S. economy had been slowing for several quarters prior to the current recession, as a tight monetary policy from the Federal Reserve interacted with a variety of serious structural problems that had been developing for a number of years. The current economic situation needs to be understood, therefore, by exploring the connections between long-term deterioration and short-term shocks.

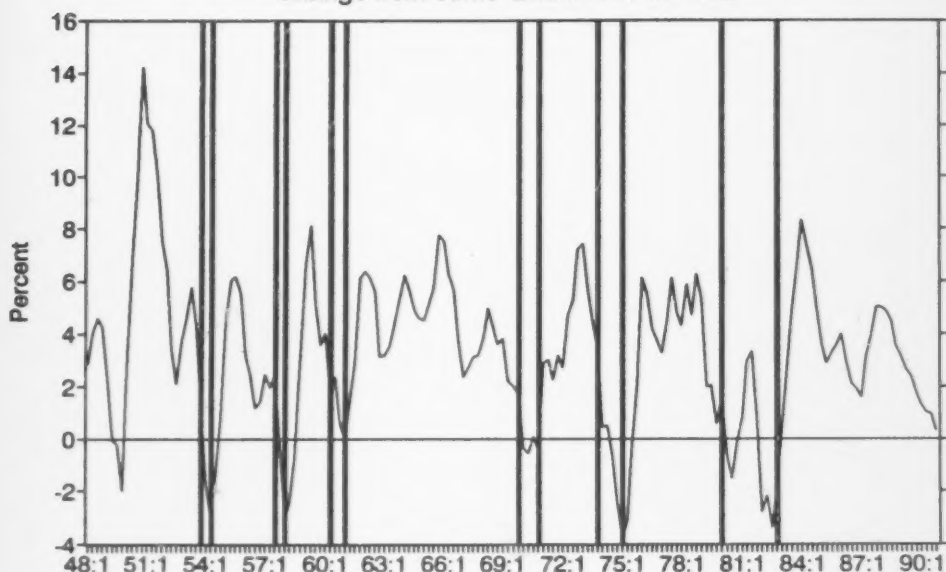
LONG-TERM DETERIORATION

Figure 1 shows the obvious pattern of decelerating growth that preceded the current recession. Real GNP grew strongly during 1988, but the growth rate has fallen off markedly since then. The unemployment rate, an early indicator of economic deterioration, started to increase in July 1990, a date that will likely prove to have been the month in which the expansion of the 1980s came to an end.

The slowing of overall GNP growth was produced by a number of factors. Monetary policy turned restrictive shortly after the 1987 crash, in an attempt to reduce the buildup of inflationary pressures in the economy. Interest rates remained high in real terms, helping to cool economic activity in most sectors. Federal fiscal policy also stopped adding stimulus to the economy after 1988.

But the deteriorating performance of the economy was the product of more fundamental problems, problems that the Joint Economic Committee has previously identified, but that have been allowed to continue unchecked. These long-term problems helped to weaken the foundations of the economy, making it more vulnerable to the shocks of 1990.

Figure 1
Growth in Real GNP
Change from Same Quarter in Prior Year

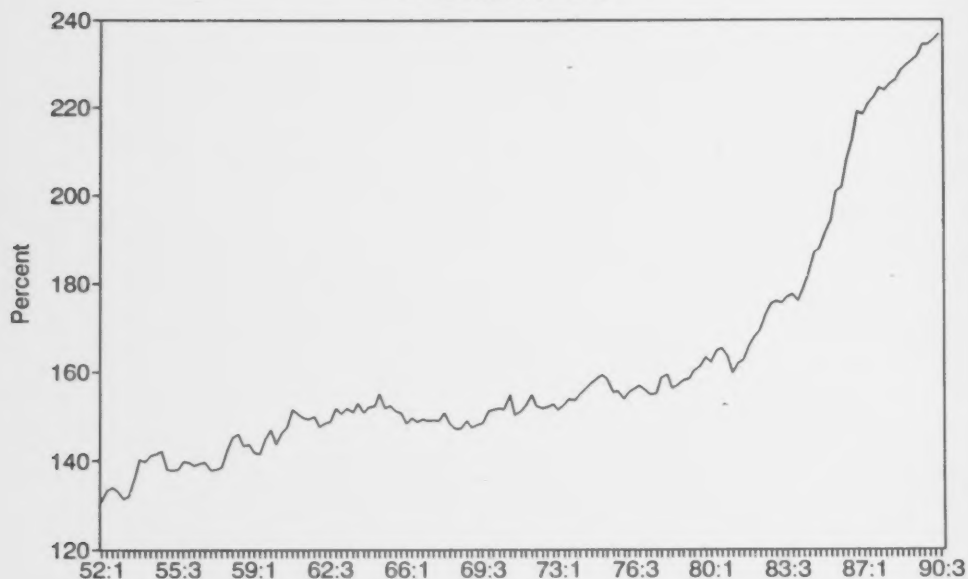


Source: U.S. Department of Commerce, Bureau of Economic Analysis.

The first of these structural problems is the enormous increase in debt at all levels in the American economy. Democrats on the Joint Economic Committee have warned of the dangers of excessive debt creation since the mid-1980s. Figure 2 shows the total credit market debt outstanding in this country as a share of GNP. Concerned about these trends, the Democratic members of the Committee noted in the *1986 Annual Report*, that "an extrapolation of the recent trend suggests that, by 1995, the United States could have \$2.25 of debt for every dollar of economic output."

As the figure shows, however, the pace of debt creation continued after 1985. By the third quarter of 1990, the United States had \$2.36 worth of debt for each dollar of economic output.

Figure 2
Total Debt Outstanding
As a Share of GNP



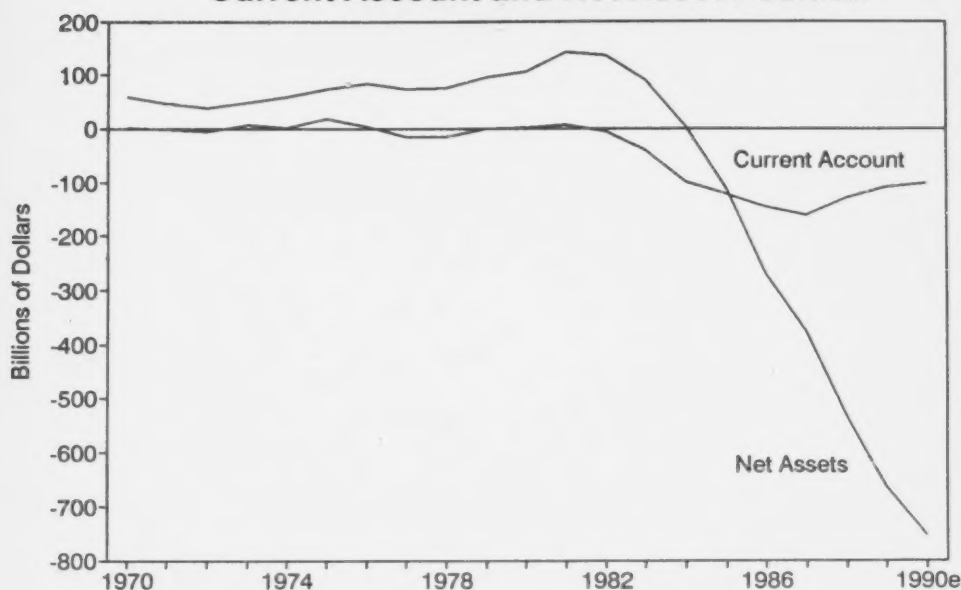
Sources: Federal Reserve Board, Flow of Funds Accounts; Department of Commerce.

This escalation of debt creates several problems for the economy. Debt must be serviced out of current income, leaving fewer resources available either for current consumption or for investment in the future. High-debt levels pose bankruptcy risks to firms in the event of an economic downturn, and these risks in turn feed back to increase threats to the stability of the financial system. High levels of federal debt create huge interest payment obligations that crowd out other important national priorities in the budget.

Debt creation has not been limited simply to the domestic economy. During the 1980s, American trade performance deteriorated so rapidly that the country shifted from being a creditor to a debtor nation. Figure 3 shows the rapid deterioration in our external debt position.

As the figure shows, the current account has shown some improvement since 1986, but remains in deficit by over \$100 billion per year. Yet, because a current account deficit of any size must be financed from abroad, the improvement in the current account has only slowed, not reversed, the accumulation of external debt.

Figure 3
Current Account and Net Asset Position

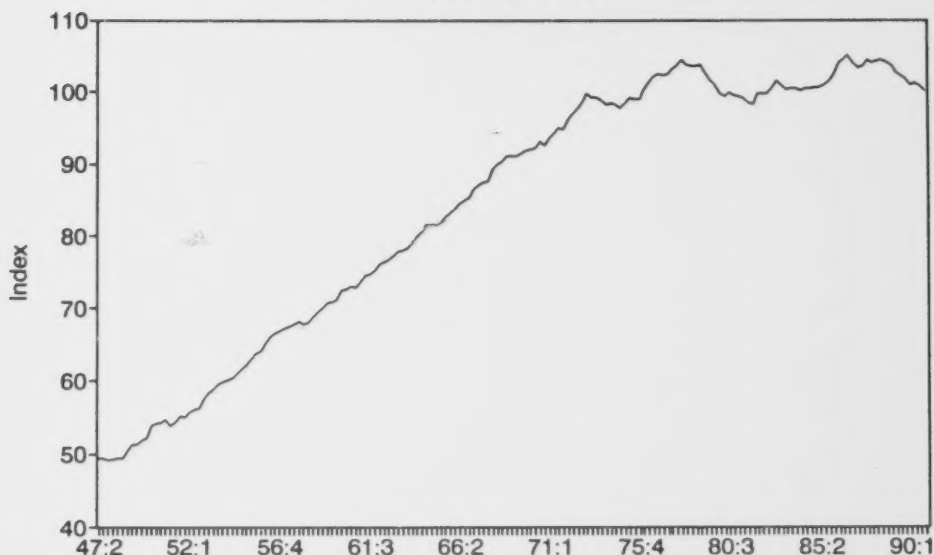


Sources: U.S. Department of Commerce; estimates Data Resources Inc.

e = Estimate.

The steady deterioration in America's net asset position poses a number of problems for the long-term health of our economy. Our net external debt represents a claim on the future output of the U.S. economy. Meeting those claims will leave less of future product available either for consumption or investment. Continued need for foreign funds to finance our current account deficit also sets limits to our abilities to manage growth in the domestic economy. As will be discussed in greater detail below, America's need to attract a steady large flow of foreign capital means that monetary policy needs to pay close attention to maintaining the confidence of foreign investors in the value of the dollar.

Figure 4
Real Compensation Per Hour
Index: 1982=100



Source: U.S. Department of Labor, Bureau of Labor Statistics.

A third structural problem is the stagnation of wage growth. Figure 4 shows the broadest and most comprehensive measure of wages, the Labor Department's index of real compensation per hour. The index includes fringe benefits as well as wages, and covers all workers in the economy. The figure shows the pattern of stagnation that prompted the Democratic members of the Committee to note in the *1986 Annual Report*: "The American economy has been doing a very poor job of generating good earnings opportunities for American workers." Unfortunately, this trend has continued. By this measure, real wages today are no higher than they were five years ago.

Stagnating wages are the most visible sign of the slowdown in productivity growth that has continued to plague the American economy. And with stagnant wages, American households have been struggling to make ends meet by working more hours, putting more family members into the labor force, and running down savings. These income pressures on households helped weaken the ability of consumer spending to keep the economy moving forward.

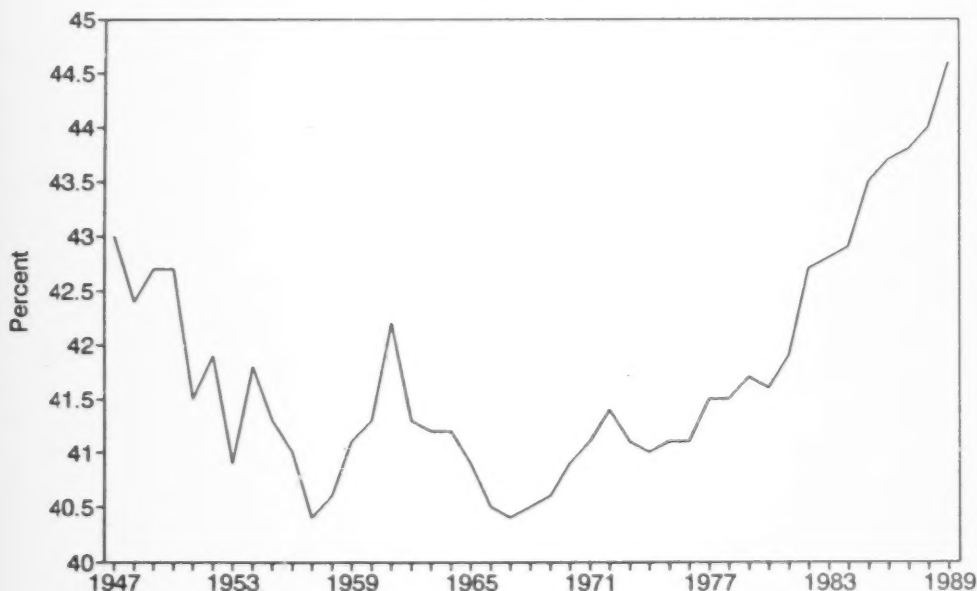
Finally, the performance of the American economy has contributed to a sharp and troubling increase in inequality of income. For several years, the Joint Economic Committee has drawn attention to this issue, and yet the problem only appears to be getting worse.

The reasons for concern can be seen in Figure 5, which traces the share of family income going to what Robert Reich calls "the fortunate fifth"--the top 20 percent of families in America. The figure shows a period of steady reduction in the share of total income of the fortunate fifth until the late 1960s, succeeded by an equally steady increase in the years following.

The data shown in the chart may even understate the problem of growing inequality. The data come from the Census Bureau, which counts all those with incomes greater than \$100,000 as having incomes of just \$100,000. The Congressional Budget Office attempted to correct for this bias by using tax return data to adjust incomes at the top. Their results, in terms of 1990 dollars, show:

Figure 5

Share of Income Going to the Top Fifth



Source: U.S. Department of Commerce, Bureau of the Census.

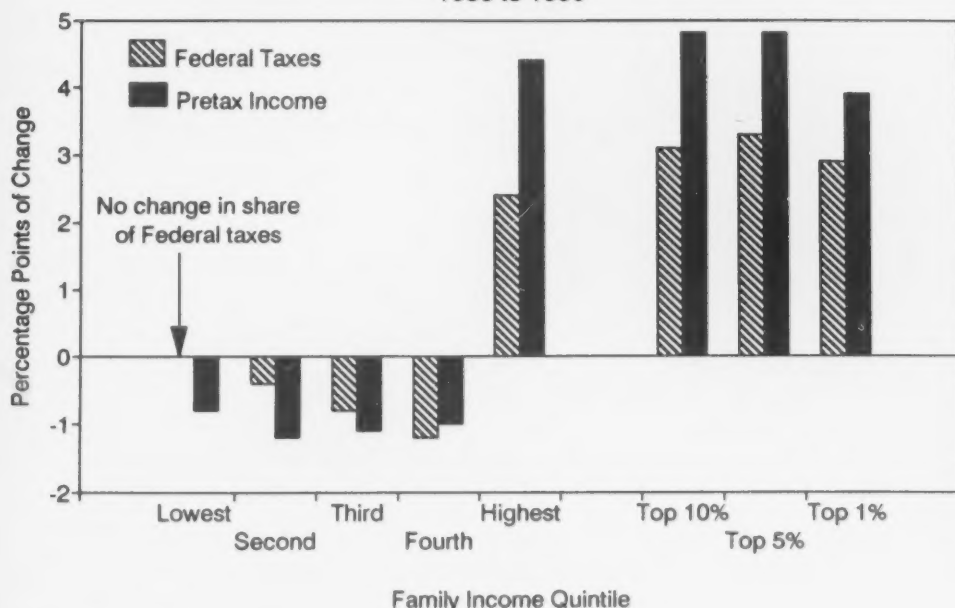
- During the 1980s, the incomes of those in the top 1 percent of the income distribution grew by **75 percent**, up from an average of \$313,206 in 1980 to \$548,970 in 1990.
- The incomes of the top 5 percent grew by 45 percent, while the incomes of those in the top fifth grew by 30 percent.
- In contrast, the incomes of the poorest fifth **fell** by 4 percent.
- Meanwhile the incomes of the lower-middle and middle-fifths of the population grew by a meager 1 percent and 3 percent, respectively. More people, including second earners, had to work more hours to achieve even these modest gains.
- In 1980, the average real income of the richest 1 percent of Americans was 61 times the typical real income of the family within the poorest 10 percent of Americans. By 1990, this ratio had nearly doubled to an incredible 117 times, \$548,969 vs. \$4,695. In 1980, the richest 1 percent had an income 11 times as great as the typical family in the middle. By 1990, that ratio stood at 20:1, \$548,969 compared to \$28,123. Where before the family in the middle made about one-tenth as much as a family at the top, now they make only one-twentieth of what the richest Americans make.

In the past, tax policy had helped to reduce income inequality, but the tax changes during the 1980s have moved American society in the other direction. The dramatic reduction in tax rates on the rich, combined with increased social insurance and excise taxes, have contributed to growing inequality.

Defenders of the economic policy of the 1980s have frequently pointed to the fact that the share of federal taxes borne by the rich has increased. Figure 6 shows, however, that while the share of taxes paid by the rich has increased, their share of income has increased much more. The tax code today is substantially less fair than it was at the beginning of the decade.

- The effective tax rate for the middle 20 percent of American families is now 4 percent above what it was in 1980.
- Contrastingly, the richest 1 percent face an effective tax rate that is fully 9 percent below what it was back in 1980.

Figure 6
Changes in Share of Taxes and Income
1980 to 1990



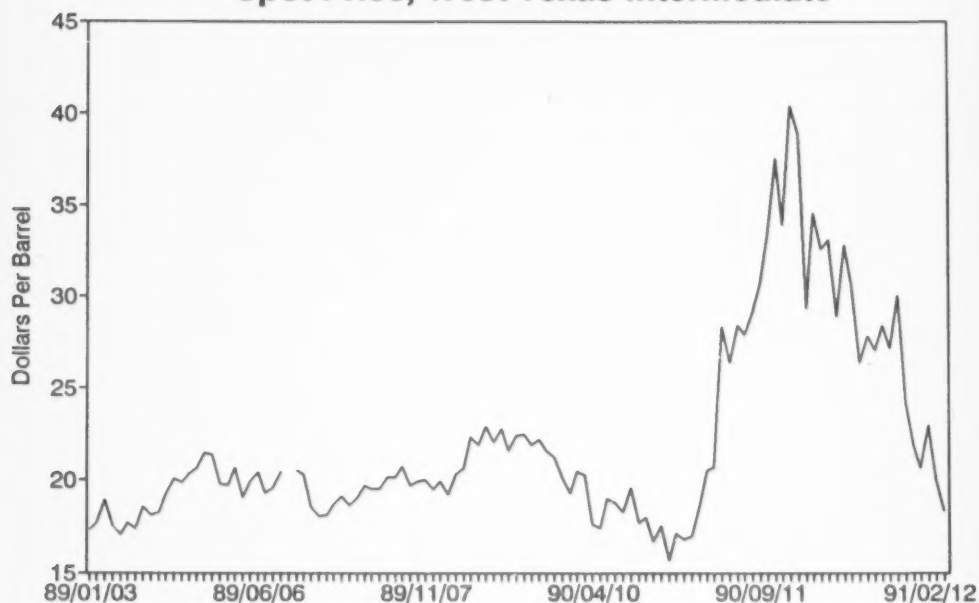
Source: Committee on Ways and Means.

SHORT-TERM SHOCKS

This troubled economy was subjected to severe disruptions associated with the Iraqi invasion of Kuwait. The shock of the invasion was transferred to the U.S. economy principally through two mechanisms: oil prices and consumer confidence.

Figure 7 shows the rapid runup in oil prices that followed the invasion. These increases affected consumer spending directly by raising gasoline and heating oil costs, and cutting into the funds available for other purchases. The increases also helped reduce business investment, because considerable uncertainty about oil prices created a bad climate for long-term business investment planning.

Figure 7

Spot Price, West Texas Intermediate

Source: *Oil and Gas Journal*.

But the oil price shock of the Kuwait invasion was not the only, and perhaps not the primary, negative influence on the American economy. The prospects of war in the Gulf created enormous concern in the minds of most Americans, a concern that was quickly reflected in a precipitous drop in consumer confidence. (Figure 8).

Drops in consumer confidence often accompany recessions, but it is rare for confidence to drop as quickly as it did in the fall of 1990. The unusually rapid and steep decline has led many analysts to conclude that the drop was associated largely with the war, rather than representing a more typical unwinding of consumer sentiment as economic activity weakened.

Figure 8
Survey of Consumer Attitudes
Index: 66 = 100



Source: University of Michigan.

The economic shocks associated with rising oil prices and collapsing consumer confidence clearly played a role in shaping the current recession. The timing of economic events suggests, however, that the shocks themselves did not cause the recession.

Dr. Geoffrey Moore, one of the country's leading experts on the history of business cycles in this country told the Committee that July was most probably the month in which the current recession began. This is confirmed by the fact that July marked the start of the sustained rise in the unemployment rate that has continued to the present. The August invasion of Kuwait may have contributed to the character of the current recession, but it does not appear to have been the proximate cause of it.

RECESSION: THE CASE FOR CONCERN

This pattern of short-term shocks imposed upon an economy with long-term structural problems makes the current recession different from past business cycle downturns. This recession was preceded by few of the typical excesses that have formerly signalled the onset of recession. But in their place, we find several structural problems that may produce a far different pattern of both recession and recovery than in past downturns.

Because of the lack of traditional excesses, there is an argument that the Federal Government should do nothing to respond to this recession. In fact, the President's Council of Economic Advisers made complacency the centerpiece of this year's *Economic Report of the President*.

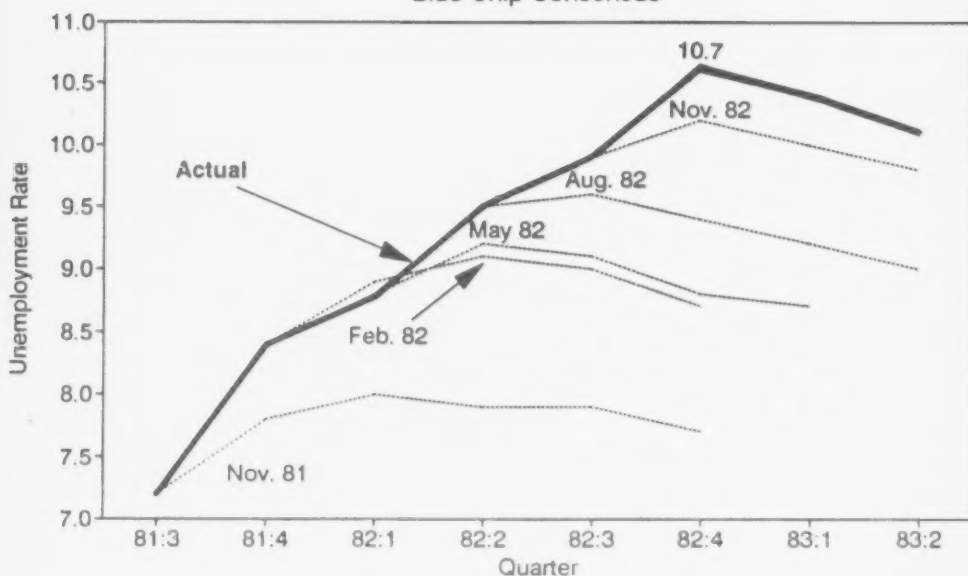
Reasons for complacency include: The absence of excessive inventory buildup in the manufacturing sector; the apparent willingness of the Federal Reserve to abandon tight money in an effort to fight the recession; the absence of serious inflationary pressures that have appeared at past business cycle peaks; a buoyant stock market; falling oil prices; and a competitive dollar that favors U.S. exports.

While it is possible to create a case for complacency, those responsible for economic policy need to weigh carefully the risks in any given outlook, not simply rely on a comforting "consensus" position. The case for concern rests on four basic propositions:

1. The Consensus Is Usually Biased Toward Optimism.

Although the consensus among forecasters is for a short and shallow recession, history provides some grounds for questioning the prescience of this consensus. Economic models, by their very nature, tend to assume that recessions are an anomaly, and that the economy seeks a rapid return to its trend growth path. As a result, forecasting models tend to miss sharp turns in the economy, and to impose a "short and shallow" bias on recession predictions. This tendency to forecast a smoother path for the economy than actually occurs is especially pronounced for the consensus of forecasting models.

Figure 9
Projected vs. Actual Unemployment Rates
 Blue Chip Consensus



Source: *Blue Chip Economic Indicators*.

This bias can be seen clearly from the "consensus" forecasts surrounding the deep 1981-82 recession. The solid line in Figure 9 traces the actual unemployment rate from a quarterly average of 7.2 percent when the recession began in July 1981, to an average of 10.7 percent by the recession's end in the fourth quarter 1982. Yet, at virtually every point during the long climb of the unemployment rate, the "consensus" forecast was for imminent improvement.

The dotted lines in Figure 9 show the path for the unemployment rate that was predicted at various points during the recession by the "consensus" of 50 economic forecasters surveyed by the *Blue Chip Economic Indicators* organization. As with the current recession, the initial consensus for the 1981-82 recession (represented by the bottom line marked "November 1981") called for the unemployment rate to rise modestly for another quarter and to decline thereafter. By May 1982, the consensus was concluding that the unemployment rate had already peaked at 9.2 percent. In fact, the unemployment rate rose by another 1.5 percent over the next six months.

Similar qualifications may apply to the "forecast" issued by the strongly rising stock market. Researchers at Columbia University have found that stock market recoveries are generally quite reliable early indicators of upturns in the economy. In most recoveries, stock market prices rise in tandem with other indicators that the Columbia researchers combine into what they call a "long leading index."

At present, however, the other components of the Columbia "long leading index" are not signalling a recovery, leading the researchers to suggest:

...that investors need to consider the possibility that the recent, spectacular advance of stock prices might turn out to be one of these rare false signals."¹

2. Consumer Spending May Remain Subdued

Optimistic forecasts of a short and mild recession place heavy emphasis on a rebound in consumer confidence following the successful conclusion of the war in the Persian Gulf. As Figure 9 demonstrates, consumer confidence had taken an extraordinary plunge in the fall of 1990, creating a situation in which, according to Federal Reserve Chairman Greenspan: "more than any other time that I can recall, this economy is driven by confidence rather than physical forces."

If consumer confidence staged a strong rebound, it would clearly be positive for the economy, but the collapse in consumer confidence noted in Figure 9 may not have been connected only to the Gulf War. If the decline in consumer confidence is rooted in factors other than the war, then the end of the war may not produce the anticipated strong rebound in consumer spending.

Consumer spending is influenced by economic factors as well as public attitudes, and the economic factors affecting families currently do not make a strong argument for a rapid rebound in consumer spending. First, as Figure 10 demonstrates, the total compensation paid for an hour of work has fallen steadily since the fourth quarter of 1986, reflecting the generally disappointing productivity growth in the economy. With wages stagnant, families have either been forced to cut their standard of living, or have maintained living standards by working longer hours, putting more family members into the work force, or dipping into savings.

¹ Geoffrey H. Moore, John P. Cullity, *The New York Times*, February 17, 1991.

Figure 10
Real Compensation Per Hour
Index: 1982=100

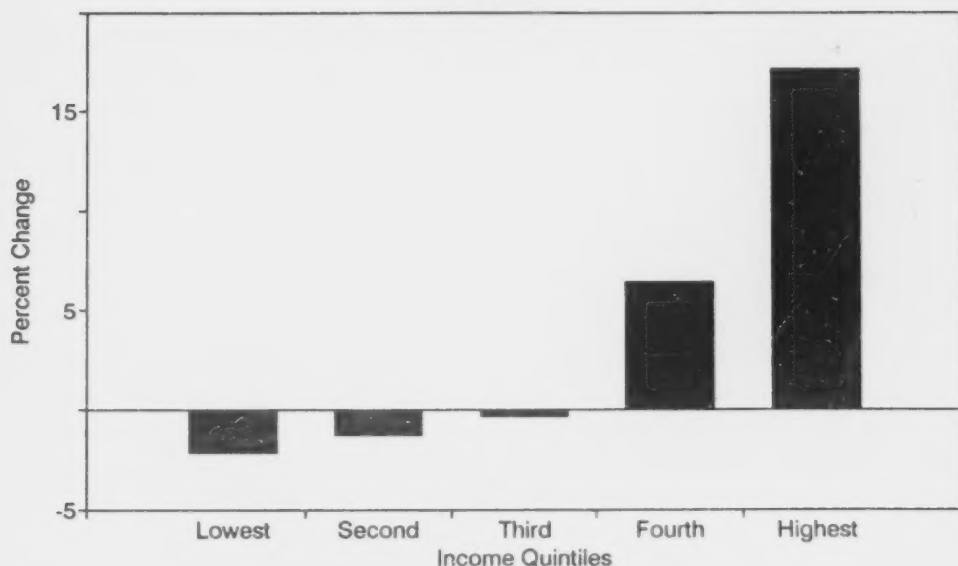


Source: U.S. Department of Labor, Bureau of Labor Statistics.

These strategies have not been sufficient to maintain adequate income growth for a majority of families. Families in the upper two-fifths have seen their incomes grow, even during this period of slow growth. As Figure 11 demonstrates, however, the other 60 percent of families have experienced either stagnation or decline in real incomes over the past decade.

These statistics suggest that large numbers of families are struggling hard to maintain living standards and are losing. Even success in maintaining family incomes exacts a high price in terms of lost family time and increased stress. Public opinion surveys have for several years picked up a marked increase in concerns about the economic future among American households, perhaps a reflection of this squeeze on living standards.

Figure 11
Change in Real Family Income
1979 to 1989



Source: Congressional Budget Office.

The current recession comes at a time when many households are confronted with new limits to their capacity to maintain living standards. Overtime and second-job opportunities are curtailed early in recessions; the labor force participation rate for women has stopped growing, reflecting a diminished capacity of families to move female labor from household work to paid work; and the savings rate, after dropping for much of the decade, began to stabilize, suggesting growing family concerns about inadequate savings in the face of economic hardship.

With diminished ability to work additional hours, employ additional family members, or dip deeper into family savings, most American households are facing severe constraints on their abilities to consume. Spirits may rebound following a successful conclusion to the Gulf War, but consumer demand may not.

3. Export Growth May Stall

After a truly shocking deterioration early in the 1980s, the U.S. trade balance has partially recovered in the last several years. Forecasts for a short and shallow recession generally anticipate significant continued

improvement in U.S. net export performance as a "growth engine" for the economy.

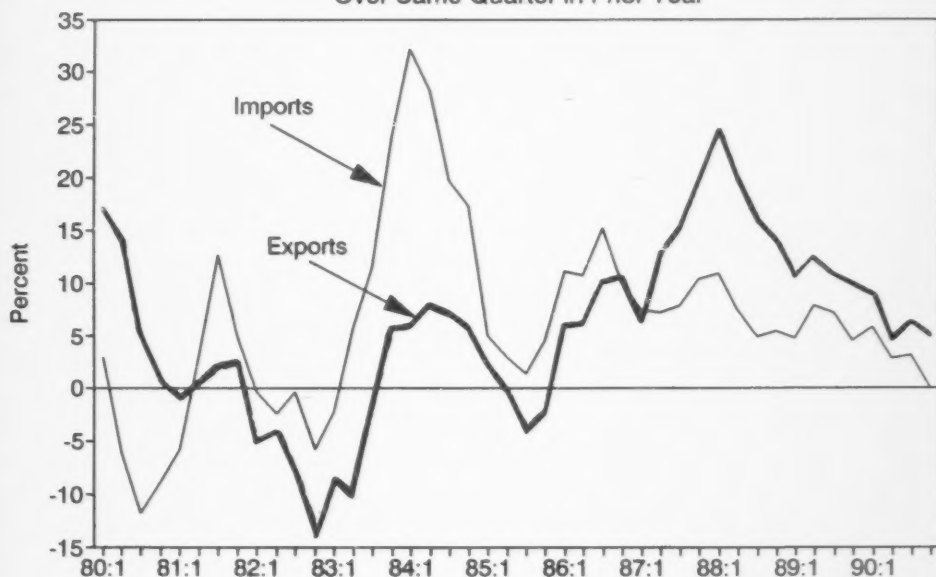
Figure 12 shows the recent behavior in U.S. trade in real terms. Price movements have to some extent concealed the fact that the rate of improvement in the U.S. trade position has slowed in recent quarters. In real terms, not only has progress toward eliminating the trade deficit slowed, but the rate of growth in exports has also fallen markedly over the past year.

Much of the case for optimism is based on the decline in the value of the dollar over the last year. Dollar declines make U.S. products more competitive in foreign markets, and there is considerable evidence, particularly in Europe, that the dollar depreciation of the late 1980s has had a strong positive effect on U.S. exports.

These positive "price effects" can be offset, however, by any marked slowing of demand growth in key foreign markets. If our major trading partners slip into recession, demand for all goods will fall, including demand for U.S. exports.

Figure 12

Changes in Real Exports and Imports Over Same Quarter in Prior Year



Source: Department of Commerce, National Income and Product Accounts.

Throughout most of the period since World War II, the major industrial countries have had individual business cycles that were slightly out of phase -- recessions in some countries are balanced by recoveries in others. The exception to this pattern came in 1974-75 when all the major economies experienced a simultaneous downturn. This simultaneous world-wide recession helped produce a long and deep recession in the United States.

There are now some disturbing signs that the world economy may be entering another synchronized downturn among all the major economies. The major English-speaking economies--the United Kingdom, Canada and Australia--have been in recession since the middle of last year, while many of the economies of Europe have started turning down in the final quarter of 1990. French GNP, for example, declined by 0.4 percent in the fourth quarter of 1990, and a number of forecasters are calling for another quarter of decline in 1991.

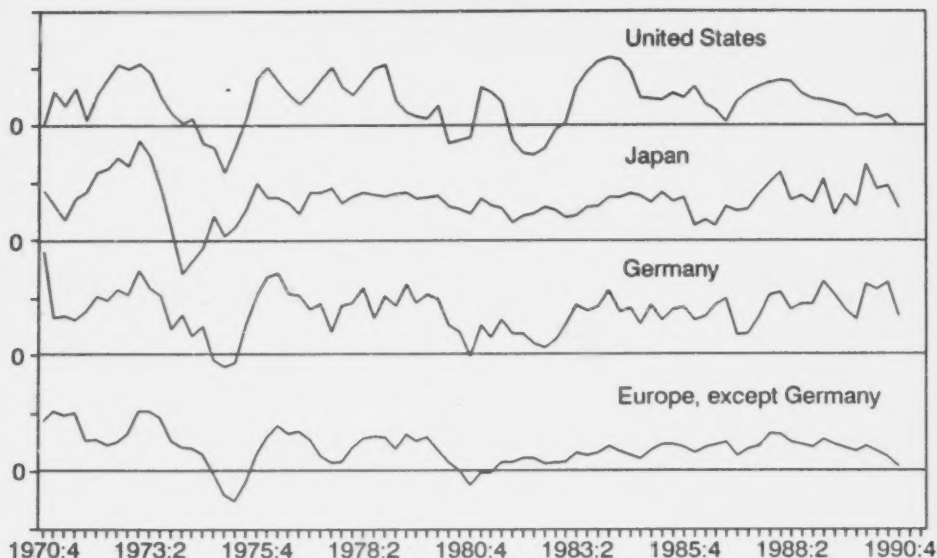
Germany and Japan, by contrast, have turned in strong economic growth performances over the past few years, and many expect them to continue in positive territory in 1991. Yet, even these economies may be slowing.

In Germany, the Bundesbank has driven interest rates to levels not seen in a generation, partly in response to the heavy demands for capital created by the integration of the Eastern Lander into the country. The Bank of Japan is following a similar course in an attempt to squeeze some of the speculative excesses out of Japanese equity and real estate markets.

As a result of these policies, growth in both Germany and Japan is slowing markedly, as is shown in Figure 13. The figure is based on the most recent forecast made by Data Resources, Inc., and shows growth in all major economies continuing to slow into the first quarter of 1991.

The trend noted in the DRI figure is also confirmed by recent work done at the Center for International Business Cycle Research. Researchers there have assembled international leading indicators for the major economies, most of which point toward continued weakness in 1991. As the Director of the Center observed, these trends are:

Figure 13
Real GNP Growth Rates
 Major Economies



Source: Data Resources, Inc.

...a bad sign for our export trade. Of the 10 countries, the ones with negative growth in their leading indexes are Canada, France, the U.K., Italy, Japan, Australia, Taiwan, and New Zealand. The only ones with positive growth rates are South Korea and West Germany. These downturns will be mutually reinforcing. Their slowdowns or declines will affect our exports; our slowdown or recession will affect their exports to us.²

4. Debt Levels and Financial Fragility

As noted earlier, the American economy starts this recession with an unprecedented level of debt on the balance sheets of firms, governments and individuals. It is difficult to predict the consequences of high debt levels in a recession, but there is ample justification for concern.

Last year, the Brookings Institution published a paper by economists Ben Bernanke and John Campbell, whose computer model showed that corporate

² Geoffrey Moore, quoted in *The San Francisco Chronicle*, December 11, 1990.

debt payments now consume such a large share of corporate cash flow that even a moderate recession could send large numbers of big U.S. manufacturing firms into insolvency. Thus far in the current recession, bankruptcies have risen markedly, but primarily in the airline, retail, real estate and financial services industries.

The problems of leverage on household and corporate balance sheets create even more serious problems on the balance sheets of financial intermediaries. The rapid expansion of debt documented in Figure 2 (page 9) was facilitated by an enormous expansion of bank credit, often in areas with high risks, such as junk bonds, loans for leveraged buy-outs, and loans for commercial real estate development in already-saturated markets.

These problems are now having a major impact on the banking system. Bank stocks are trading at record discounts, with price/earnings ratios of about 4.5, compared with the S&P 500's 12. Some large banks have had to pay double-digit rates of interest on their preferred stock, a sign of diminished investor confidence.

Commercial bank failures are also growing. The failure of the Bank of New England put more assets into bankruptcy than all 169 of last year's bank failures combined. The shaky state of the banking system poses two risks to the economy. First, the failure of insured institutions creates new liabilities for taxpayers, who are responsible for making good on deposit insurance. Second, any serious decline in bank assets threatens the ability of the financial system to play its traditional role in the center of the economy's money-creating process.

Banks create money in the economy by extending loans to borrowers. The Federal Reserve helps manage the process of money creation by adjusting the level of reserves in the banking system. Banks are also required to maintain ratios of capital to total assets as a way of protecting the financial system against undue risk of bank failure. As the recent study of the banking industry by the Treasury Department reported, U.S. commercial banks currently operate with a very thin cushion of capital--an average of 6.2 percent of assets for the banking system as a whole, and 4.8 percent for the 25 largest banks. A recent international agreement among bank supervisors is designed to raise these capital ratios significantly for U.S. banks in the near future.

Today's weakening economy interacts with a thinly-capitalized banking system to create the potential for serious credit disruption. Banks are required to increase capital at a time when the value of assets in their portfolio is declining. Since assets are, on average, 16 times larger than capital, a sharp fall in bank asset values could wipe out the thin capital

cushion held by banks. Without adequate capital, banks cannot lend and the credit system is in danger of freezing up, thus delaying the recovery considerably.

Unfortunately, throughout much of 1990, the Federal Reserve underestimated the potential threat to the economy posed by distress in the financial services industry. Now, however, it seems that they have acknowledged the critical problems in this sector and are taking steps to deal with them. But as Professor Benjamin Friedman of Harvard notes, both the Federal Reserve and the banking system are moving in uncharted waters. He notes: "There is a financial fragility now that hasn't been seen in our lifetimes,"³ Federal Reserve Chairman Greenspan made a similar point in his testimony to the Senate Banking Committee.

The major danger to the near-term recovery is that the erosion in purchasing power and frayed consumer and business confidence stemming from the recession and war could interact with a weakened financial system to produce a further decline in the economy.

The unique constellation of economic forces in the current environment clearly creates new risks that the recession will be longer and deeper than is anticipated by the current consensus of economic forecasters. While we have some optimism that the economy will weather the current period of adversity, we believe that these risk factors justify increased attention by the Congress, the President, and the Federal Reserve to policies that could stimulate economic activity should the optimistic consensus be proven wrong. As the Federal Reserve Board observed in its February 20, 1991 *Monetary Policy Report to the Congress*:

...the Board members and the Bank presidents perceive that, in the near term, the risks to the economy may be skewed to the downside.

If the risks are skewed on the downside, then additional thought should be given to how to get the economy moving again.

³ *Newsweek*, November 12, 1990.

RESPONDING TO THE RECESSION

Today's recession presents a new kind of challenge to economic policy. It has started after a prolonged slowdown in economic activity and in an environment of unprecedented deterioration in the financial position of economic actors and intermediaries. Although the consensus forecast is for a short and shallow recession, these conditions are sufficiently troubling that we may well need a more active counter-cyclical role for government than is required in a routine business cycle downturn.

The basic tools available to government for moderating recessions are monetary policy and fiscal policy. In the present recession, monetary policy clearly has the lead role to play in restoring economic activity. Fiscal policy is sharply constrained, both by the size of the federal budget deficit and by the budget agreement worked out between the Congress and the President last year.

MONETARY POLICY

The Federal Reserve has eased monetary policy recently. For several quarters, however, economists had been expressing concern that the Fed was keeping money and credit too tight in the face of a weakening economy. In his testimony before the Senate Banking Committee, Chairman Greenspan confirmed that the Board of Governors had now come to share the view that the Fed had been too tight for too long:

We still find that, as I've said before, we have got a rate of growth in money supply, or at least have had, which we consider to be subnormal, and have taken actions in recent weeks specifically which seems at this stage to have moved the trend up significantly.

It now appears that monetary authorities have the latitude to use monetary policy to get us out of the recession. Oil prices are retreating, the dollar has stabilized on international markets, and at least short-term interest rates are falling with the Federal Funds rate as the Fed eases. There remain, however, three questions concerning the effectiveness of monetary policy in countering the current recession.

Inflation and The Dollar

The first concern relates to the ability of the monetary authorities to push interest rates down further. The Federal Reserve has scope to ease as long as inflation and the dollar remain under control. At the moment, economic weakness and falling oil prices seem to be working to moderate inflation, and the value of the dollar is holding up well in foreign exchange markets. Yet, financial markets remain volatile, concerned about both a resurgence of inflation and a fall in the value of the dollar. Long-term interest rates, for example, have not yet shown much response to the monetary ease evident in the decline of short rates.

We believe that current inflationary pressures seem to be abating, and that the Federal Reserve should not be overly concerned about nervousness in financial markets. Relatively large increases in producer and consumer prices at the beginning of this year can be explained by special factors, such as the slow pass-through of last fall's oil price shock into other goods and services, new federal excise taxes, and the drought in California. In our opinion, these factors are transitory and should pose no obstacle to a further easing of monetary policy by the Federal Reserve.

This opinion was shared by the private sector forecasters who appeared before this Committee to discuss the near-term outlook. None argued that inflation was likely to be a serious problem, and several argued that inflationary pressures would abate quickly. Data Resources, Inc. is calling for a moderate 3.5 percent inflation rate over the coming year, and the leading index for inflation prepared at the Columbia University Center for International Business Cycle Research moved sharply downward in the most recent months.

Concern for the dollar may be a more realistic worry, but again we believe that monetary policy in the present moment needs to focus primarily on combatting the recession. Our continuing need to borrow from abroad means that the United States is now more sensitive to international interest rates than in the past. The recent decisions by Japan and Germany to tighten monetary policy have put pressure on the dollar and on the Federal Reserve to raise interest rates in defense of the dollar.

As we argue elsewhere in this *Report*, we believe that the monetary decisions of Germany and Japan are raising the risk of a worldwide recession, and we believe that steps toward ease are justified in both countries. Such moves would give the Federal Reserve substantially more latitude to ease, which is precisely what the economy needs at this moment.

Given the severity of the current downturn, we are inclined to support the views of DRI Vice President Roger Brinner, who argued the case for further monetary ease before the Committee in the following terms:

I would argue we need another full percentage point cut as soon as possible. Stated another way, the Fed should buy catastrophic economic insurance. It needs to lessen the risk tied to a scared consumer, a stressed banking system, and a depressed construction industry. If the economy is sicker than I assume and the Fed does not act, the business and employment losses will be severe. If the economy is basically healthy and rebounds strongly with greater Fed help, the only cost of buying this policy, this catastrophic economic insurance policy, would be higher inflation for the next few years. Insurance is a good buy.

In light of these considerations, we do not believe that concerns about inflation and the dollar are sufficient justification for slowing the pace of monetary easing that is so urgently needed by the domestic economy.

The Supply of Credit: "The Credit Crunch"

A second problem concerns the capacity of the financial system to translate an easing of monetary policy into an expansion of credit--the much-discussed "credit crunch." There can be no doubt that one of the principal casualties of the excessive and imprudent debt creation of the 1980s is the financial sector. The savings and loan problem has received wide public attention, but a similar pattern is also unfolding in the commercial banking area.

Federal Reserve Chairman Greenspan devoted a large portion of his testimony before the Committee this year to a discussion of the credit crunch problem. In his words:

I do think, however, that we got to the point sometime during the summer of 1990 when we went over the line, if one could basically draw it, and credit was being deprived in a number of instances from otherwise creditworthy borrowers who by any set of criteria were good loan candidates and candidates which would be profitable to the commercial bank and generalized, would enhance the franchise for the commercial bank. In a sense, I am saying that the commercial banker, the loan officer, are acting against their own long-term self-interests

Commercial bankers taking this stance because past lending practices have undermined the financial position of the industry. The basic problem is that U.S. financial institutions have made too many loans for which there is now considerable doubt about the ability of the borrower to repay. Banks are required to set aside reserves for potential problem loans, and write off those on which payments have actually stopped, both of which subtract from bank earnings. Yet at the same time, banks must increase their core capital to satisfy regulatory requirements on capital adequacy. Under these circumstances, according to Chairman Greenspan:

banks are fearful that extending new loans for certain industries or for certain purposes will end up nonperforming and cut into their capital base. So long as they believe that, it is very difficult to induce them to lend. You can obviously increase their balance sheets. They will buy Treasury bills. But you cannot make them pick up commercial loan or real estate loan unless they believe that it will be paid back and it will be profitable.

Shrinking earnings and an eroding capital base have created an environment in which many banks are denying credit to projects that they might easily have funded in an earlier period. Financial economist, David Jones, described this pattern as a "grass roots credit restraint." According to Jones, this pattern contrasts with past credit crunches caused by monetary tightening. He notes:

The distinguishing feature of the current grass roots restraint on the supply of credit is that it is arbitrary, selective, and unpredictable, affecting certain types of borrowers in many but not all regions of the country.

Not only are many banks denying credit to borrowers, they also are charging high interest rates on the loans they do make. Continuing to charge high rates on loans as the rates paid on deposits fall helps banks to rebuild earnings and capital, but it does not translate the stimulus of lower interest rates to borrowers in the economy. These concerns do not appear to have been fully taken into account as monetary policy moves toward ease.

Some sectors of the economy have avoided credit problems from banks by turning directly to the securities markets. Total credit in the economy grew at 7 percent last year, while bank-intermediated credit as measured by M-2 grew at only half that rate. Yet, credit problems also exist in the non-bank sector. Insurance companies have cut back on real estate lending, and many smaller firms have lost access to the securities markets because of the highly-publicized collapse of the "junk bond" market.

For all these reasons, we believe there are some grounds for David Jones' assessment that:

the current recession's responsiveness to Federal Reserve monetary easing actions may be far more delayed and sluggish than was the case in past recessions

The Demand for Credit

The third problem concerns the response of firms and households to an easing of monetary policy. Monetary policy is an effective anti-recessionary tool as long as banks respond to an easing of money and credit by increasing their lending and consumers and businesses respond by increasing their spending. Otherwise, monetary policy is no more effective than pushing on a string.

Monetary policy stimulates economic activity primarily through the mechanism of lower interest rates. For the consumer sector, lower interest rates both free up income from current debt service and make it more attractive to borrow. For borrowers, lower interest rates can thus provide a powerful stimulus to demand. For businesses, lower interest rates lower the cost of capital and make it more attractive to invest.

Lower interest rates make it easier for households to consume and businesses to invest, but there must be attractive consumption and investment opportunities available. Households might prefer to use the income freed up by lower debt-service payments to reduce their outstanding debt further or build up savings. Overbuilding in the residential, and especially the commercial, real estate markets has left inventories that will have to be worked off before new construction becomes profitable once again.

With the onset of the recession, for example, housing starts have plummeted to their lowest level since January 1982. The speculative overbuilding of office space in many cities during the late 1980s has left a legacy of "see through" buildings that could also take several years to work off. Considering these problems in the real estate sector, a survey of 1,633 real estate executives found 72 percent predicting at least two to five years for the industry to come out of deep slump.

Outside of real estate, business investment may exhibit only a muted response to falling interest rates because of changes in their balance sheets. Highly leveraged corporations with improving incomes may respond to falling interest rates by retiring old debt rather than taking on new investment. This would not add to real economic activity.

FISCAL POLICY: AUTOMATIC STABILIZERS

Given these questions about the ability of monetary policy alone to generate a recovery, attention needs to be given to the contribution that fiscal policy could make to spurring recovery. In a business cycle downturn, fiscal policy can help stimulate economic activity in two ways. First, taxes fall and income-maintenance spending rises automatically as the economy deteriorates, cushioning taxpayer incomes from the full effects of decline. Second, policy can be changed at the discretion of the President and the Congress to provide a greater degree of stimulus to the economy.

In this year's *Economic Report of the President*, the Council of Economic Advisers placed great emphasis on the efficacy of automatic fiscal stabilizers to mitigate the effects of the current downturn. Yet on closer examination, it appears that one of the key automatic stabilizers--Unemployment Compensation--has lost much of its traditional capacity to cushion the income losses associated with recession. At the same time, balanced budget requirements force state and local governments, many of which are already financially strapped, "automatically" to raise taxes or cut spending as the recession reduces their tax base. This drains purchasing power from the economy, deepening rather than mitigating the current downturn.

Unemployment Insurance

As a quick targeted program of income replacement for jobless workers, the UI system is ideally suited to serve as a fiscal stabilizer. Funds are spent immediately without the lags of bureaucratic or political decision-making typical of other countercyclical spending. Moreover, the funds are automatically spent in the locations of greatest distress.

The UI system is not performing its stabilization role as well during this recession as it should. As a result of four key changes, unemployment insurance is replacing workers' lost income only half to two-thirds as well as it did in past recessions: 1) eligibility rules have been tightened, reducing the fraction of job losers receiving benefits; 2) funds to administer the program are inadequate, causing unnecessary delays and benefit denials; 3) UI benefits have become taxable with no corresponding increase in the level of benefits, reducing their after-tax value; and 4) far fewer workers are eligible for UI benefits beyond the standard 26 weeks during this recession than during any recession since the 1950s.

Falling Eligibility. Until the late 1970s, the number of UI recipients closely tracked the number of "job losers," i.e. those among the unemployed who had involuntarily lost their last job. The deep recession of the early

1980s left many states with UI trust funds in substantial debt to the Federal Government. To repay these debts, many states not only raised UI taxes but also tightened eligibility requirements. The tougher eligibility requirements are reflected in a significant decline in the number of UI recipients. In the 1980s, the number of UI recipients has fallen to four-fifths of the number of "job losers" (those who involuntarily lost their job through layoffs, shutdowns, firing, etc.), as shown in Figure 14.

Inadequate Funding for Program Administration. The downward trend in eligibility is being exacerbated in the current recession by an anomaly in the budgetary treatment of UI included as part of last year's budget agreement. While the agreement excludes spending on UI benefits from the spending caps, spending on administration of the UI program is included in the domestic discretionary spending cap. The recession that began last year has so increased UI claims and the burden on UI offices that administrators of the state UI programs are unable to manage the program within existing budgets for administration. Many unemployed workers living paycheck-to-paycheck are receiving their first UI benefit check four to six weeks after application. They are supposed to receive checks within one to two weeks.

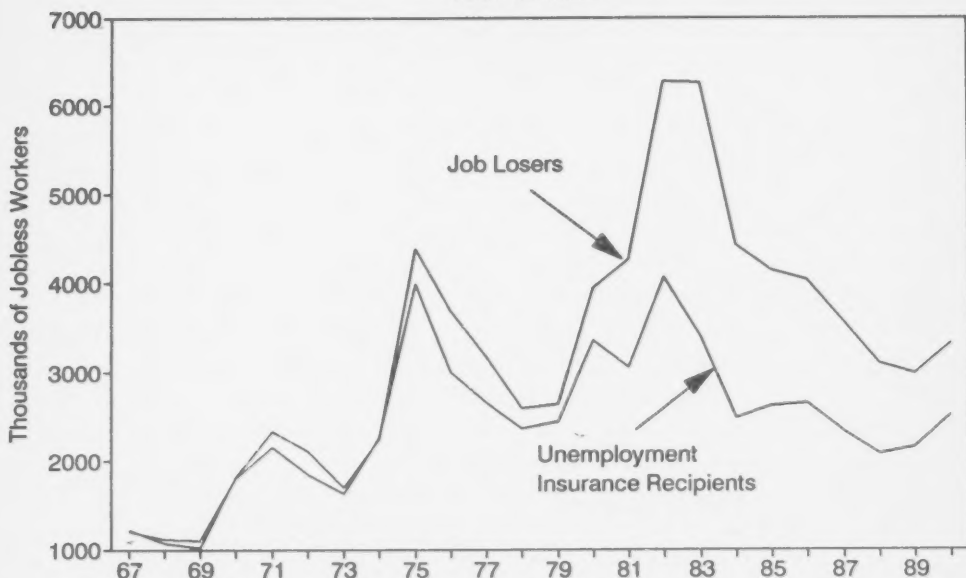
The shift from a deficit cap to spending caps in the budget process was intended to permit cyclically sensitive programs to respond to the business cycle. Debate over deficit-cutting was to focus on structural aspects of the budget. Yet, no provision was made to provide UI administration funding for cyclical increases in the workload.

Members of the Joint Economic Committee believe that current provisions for funding the administrative costs of the UI system are unacceptable. It makes no sense to have a program where benefits and claims expand automatically with a deteriorating labor market, but the administrative funds needed to process those claims remain frozen.

As a first step, we believe the Administration should provide the additional funding needed to meet the expanding caseload in the system. The funding of administrative costs should be consistent with the funding of claims costs, and therefore be provided under the "emergency" provisions of last year's budget agreement. However, this emergency funding would only affect FY91. It is also necessary to enact a solution for future fiscal years that permits more flexible spending for UI administration in recessions.

Figure 14

Job Losers and Unemployment Insurance Recipients 1967 to 1989



Source: Congressional Budget Office.

The Taxation of Benefits. In the last decade, the Federal Government has moved from imposing no tax on UI income to taxing it entirely like ordinary income. For at least two decades, UI benefits have increased roughly in line with inflation, while they have not been raised to offset the increase in taxes. The marginal federal income tax rate for most UI recipients is 15 percent. Most states impose income taxes that follow the federal example for taxable income. Thus, for most UI beneficiaries receiving the average \$2,000 total payment, the imposition of taxes has reduced net income by \$300 to \$400. This new taxation without a compensating benefit increase has reduced both the humanitarian and countercyclical effects of the program.

Outmoded Triggers for Extended Benefits. For workers threatened with job loss, the UI system provides "insurance" in the form of income support for a reasonable period to find a new job. In normal times, virtually all states set a maximum income-support period of 26 weeks. However, during a recession (regional or national), the chances of finding a job within 26 weeks are greatly reduced. To provide equivalent "insurance," the reasonable period of time to find a job should be extended. Since 1970, U.S. law has recognized this and provided for "Extended Benefits" (EB) up to an

additional 13 weeks during particularly adverse conditions. In addition, during every recession since 1957 that lasted more than five months, the Congress has enacted temporary provisions to lengthen the period for receiving UI benefits.

The formulas used to initiate EB payments have become increasingly outdated due to changes in the UI system and in the labor market. In testimony before the JEC on January 4, Gary Burtless likened the current EB trigger to a malfunctioning thermostat on an air conditioner:

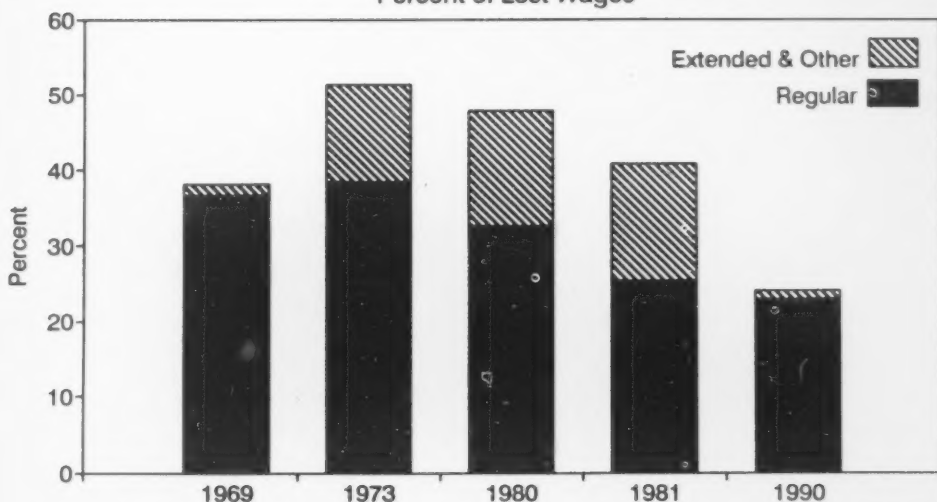
The broken thermostat will certainly save you a lot of money over the course of a hot summer, but it will not keep the house very comfortable. The [current EB trigger] is like the broken thermostat; it takes a lot of unemployment before this particular thermostat registers recession.

Another witness, Wayne Vroman, estimated that unemployment must reach 15 percent for the EB trigger to be reached in some states.

Since enactment of the EB program in 1970, the level of total unemployment required to trigger Extended Benefits has effectively been raised by 40 percent. Since EB is triggered by a state's insured unemployment rate ("IUR": the number of UI recipients relative to the number of workers employed and covered by UI), this has the effect of raising the EB trigger by one-fourth. However, the effects are very uneven. While some states would require total unemployment rates as high as 15 percent to trigger EB, a few small states with much lower unemployment rates will be triggering EB in coming months.

Taking all these factors into account, UI provides substantially less income replacement in the current recession than it has in the past. The UI system's capacity to stabilize the economy can be measured by comparing the increase in UI benefits during a recession with the income lost by job losers. As shown in Figure 15, the ratio anticipated for this recession is much lower than in the last four recessions. The regular 26 weeks of benefits are projected, on the basis of the Administration's Budget numbers, to replace 10 percent less of unemployed job loser's missing paychecks than in 1981-82 (the difference from some earlier recessions is even larger). If the current recession lasts longer than the Administration forecasts, this replacement ratio will decline, because more workers will exhaust their eligibility. Yet, longer-term benefits are now projected to make up only 4 percent of the cyclical rise in UI payments in 1990-91--far smaller than in past recessions as shown by the shaded portions of the figure. This decline is the result of changed trigger levels in the existing "extended benefits" program, along with the termination of the "supplemental benefits" program that had helped

Figure 15

Replacement of Lost Income in RecessionRise in Unemployment Insurance Benefits as a
Percent of Lost Wages

Sources: Department of Labor and Joint Economic Committee.

Note: Lost wages are the peak to trough change in wages that would have been earned by job losers.

support incomes in the last recession. All of the factors discussed above have contributed to this decline in the system's effectiveness as a counter-cyclical tool.

State and Local Finance: The Automatic Destabilizers

Many of the Nation's state and local governments entered the current recession with fiscal problems and balanced-budget requirements that leave them no options other than to cut spending and employment or to raise taxes as the economy declines. As a result, the state and local government sector may act as an "automatic destabilizer" in the current recession, offsetting some or all of the automatic stabilizers, such as unemployment insurance, in the federal budget.

According to the National Governors Association and National Association of State Budget Officers, more than 30 States will face deficits in FY91 if they do not cut spending or raise revenues. The shortfalls range from less than 1 percent of expenditures in Minnesota and Colorado to almost 13 percent in Virginia. On average, states face deficits equal to 3.2 percent of

expenditures, or a total of \$9.6 billion. Erasing this deficit would thus constitute a \$10 billion fiscal contraction that will grow even larger as the recession saps state revenues further.

In the past, state and local governments have been able to maintain spending in the face of recession by dipping into their "reserve balances"--funds set aside during expansions for use in unanticipated contingencies. But because the recovery of the 1980s was a comparatively weak one, state reserve balances were not built up to levels seen at the start of past recessions. State reserve balances amounted to barely 3.3 percent of expenditures at the end of FY90, compared to 9.0 percent going into the 1981-82 recession.

Numerous cities are also in fiscal distress. According to a January 1991 survey by the National League of Cities, 40 percent of municipal governments will need to cut services during the next year unless they raise taxes. Twelve percent cut services in 1990 and 27 percent report they are unable to keep up with their community's infrastructure needs. Matters will only get worse during the recession.

The short-run budget pressures result mainly from the slow growth of the economy during the past two years, and the recession that began toward the middle of 1990. State and local governments that depend on income, profits and sales taxes have been most adversely affected, since these revenues tend to rise and fall with the economy. Finances that depend on property taxes and user fees have also been affected in certain localities.

But the normal budget problems that occur during a recession are compounded by the fact that federal assistance to state and local governments was severely cut during the 1980s. Federal grants fell from more than 25 percent of state and local expenditures in 1978 to only 17 percent in 1990. At the same time, the Federal Government has shifted a number of programs and responsibilities onto state and local governments, particularly in the areas of housing, education, mass transportation, infrastructure, and aid to the poor. As a result, when revenues decline as they do during recession, the fiscal distress of state and local governments grows even worse.

The current fiscal condition of state and local governments makes it increasingly likely that they will cut jobs during this recession. Employment by state and local governments declined substantially during the 1981-82 recession. If that happens during the current recession, as appears likely, state and local budgets will act as automatic destabilizers, reducing the effects of the automatic stabilizers in the federal budget.

FISCAL POLICY: DISCRETIONARY STABILIZERS

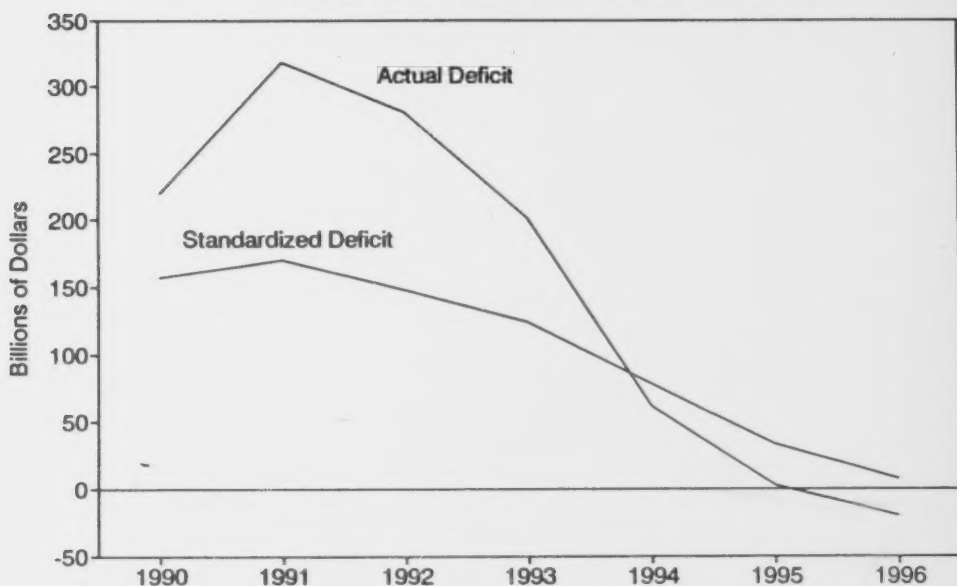
These calculations suggest that automatic stabilizers will not be as effective as they have been in the past. If fiscal policy is eventually called upon to play an important stimulative role, it may have to come from discretionary, rather than automatic changes in fiscal policy.

A shift toward stimulus in the federal budget would represent a major turn in policy. The Budget agreement put discretionary fiscal policy on a contractionary path, although this is not immediately evident, given the apparent ballooning of the deficit this year and next. For purposes of analyzing the impact of the budget on the economy, however, economists find it more useful to measure the stance of fiscal policy at a standardized level of economic activity (typically a high-employment level). This procedure removes the effects of automatic stabilizers and focuses attention on the fiscal impact of the underlying policies.

Identifying the underlying fiscal impact of the budget over the next few years is further complicated by special factors relating to the S&L bailout. In large measure, deposit insurance outlays do not contribute to current disposable income or spending. The economic losses from poor S&L management and oversight have already been borne; depositors' wealth and income, and hence their future spending behavior are largely unaffected. Acquiring the assets of failed S&Ls contributes to the measured deficit but not to the fiscal impact of the budget; subsequent sales of those assets will reduce the measured deficit, but will not affect the fiscal impact of the budget.

Figure 16 compares the Administration's projection of the actual budget deficit with its calculation of the standardized deficit without cyclical factors and deposit insurance outlays. Compared to the behavior of the actual deficit, the standardized deficit indicates the steady tightening of our fiscal stance embodied in the Budget agreement.

Figure 16
Actual and Standardized Deficits



Source: Office of Management and Budget, 1991-96 data are estimates.

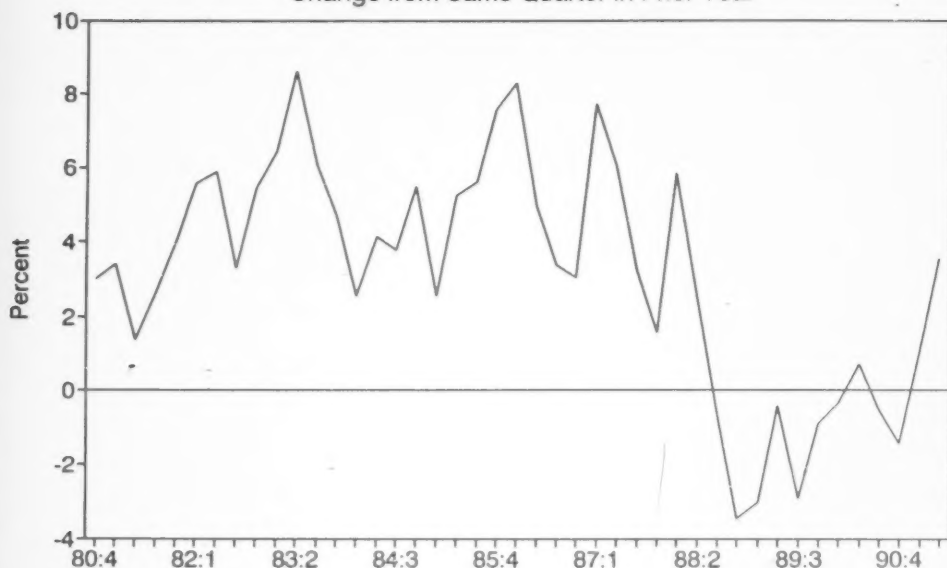
War and Reconstruction

A special factor in the budget that may have a temporary fiscal impact is the cost of the war in the gulf. As Figure 17 shows, government military spending jumped in the fourth quarter and will do so again in the first quarter of 1991. These increased purchases affect real GNP only in so far as they are met by expanded domestic production. War material purchased abroad, or weapons taken out of inventory, do not in themselves contribute to expanded domestic production. Much of the current addition to spending is devoted to increased purchases of fuel from the Gulf states. Furthermore, the large decline in December durable goods inventories may be associated with shipments of spare parts that private firms previously had held in stock.

Figure 17

Growth Rate for Real Defense Purchases

Change from Same Quarter in Prior Year



Source: Department of Commerce, National Income and Product Accounts.

Though the crisis in the Gulf had little effect on real GNP in the fourth quarter, it may have a more substantial effect in the first half of this year. Employment declines have already flattened out for some nondurables industries (food, textiles and apparel) that may have increased shipments to the armed forces. Furthermore, employment in transportation industries has risen recently, perhaps stimulated by the need to move personnel and material to the Middle East. The end of hostilities does not signal an end to the need for supplies and, beginning soon, the transportation of troops and material back home. Furthermore, the U.S. economy should get some boost from Kuwait's expenditures to rebuild its economy.

The impact of the war on production in future quarters is highly uncertain. Much depends on the extent to which destroyed weapons and equipment are replaced and on the size of foreign contributions that actually come in. Standard measures of economic activity will be greatly distorted by the large and complex transactions associated with the war and subsequent peacekeeping and reconstruction efforts. The national income accounts, budget estimates, merchandise trade and current account measures all will be affected, and the war's actual impact on the economy will not be clear for some time.

The war has diminished our inventories of ammunition and missiles. The Pentagon's supplemental request indicates a need for resupply of several types of weapons. But much of the material expended in Desert Storm came out of stockpiles deemed appropriate to the Cold War but not, with the dismantling of the Warsaw Pact, to current conditions. Thus, except perhaps in a few key areas, there would appear to be little continuing fiscal stimulus from the rebuilding of inventories.

Additional Discretionary Changes in Fiscal Policy

At the moment, the economic recovery is being assisted now by the reversal of oil prices and some modest monetary ease from the Federal Reserve together, possibly, with some modest stimulus from Desert Storm expenditures. Despite fiscal austerity at the state and local level and weakening of the federal automatic stabilizers, it is possible that the policy environment is sufficiently supportive for the economy to stage a recovery from the current recession. It is also quite possible that the recession will be more persistent than anticipated, raising the need to consider additional fiscal measures to stimulate the economy.

Given the history of fiscal policy in the 1980s, any moves toward fiscal stimulus will need to be very carefully considered. The Federal Government entered this recession with a fiscal deficit far in excess of those prevailing at other business cycle peaks. If financial markets were to perceive that the budget discipline embodied in the agreement was being ignored, there could be a large adverse impact on interest rates and the economy. If, in contrast, specific expenditure increases were perceived as part of a prudent counter-cyclical policy aimed at preventing a severe recession, financial markets need not find them troubling.

This Committee believes that new initiatives in two areas could meet the standards set forth in the preceding paragraph.

First, unemployment insurance remains our most productive and effective countercyclical tool. Steps to strengthen it by providing additional benefits to the unemployed should be our first priority.

Improving the UI system is an obvious first step in a more active counter-cyclical policy. In addition to the obvious value of the program in supporting the incomes of the unemployed, UI also plays an important role in raising the productivity of the economy. For millions of people who work hard and pay their bills, but still live paycheck to paycheck, the safety net of unemployment insurance means that, if they suddenly find themselves jobless, they need not desperately take the first available job to keep their creditors at bay. Instead, they have some time to survey the market for an

appropriate job suited to their skills and interests. Better matching of workers and jobs results in a more productive economy.

In addition to improved matching, the UI system provides assurance of some income support to workers considering more productive jobs that carry greater risks of job loss. Without such assurance, our highly productive manufacturing and mining sectors would have greater difficulty in attracting productive workers. By the same token, the program is designed to impose a higher tax for employers with higher layoff rates.

To maintain an appropriate level of "insurance," the trigger for longer term UI benefits in a recession may need to be recalibrated. Given the wide divergence among states in eligibility requirements, and therefore their IUR rates, the recalibrated trigger should not hinge on the IUR. Another measure, such as the total unemployment rate, would better reflect the chances of finding a job within 26 weeks and not the stringency of a state's eligibility criteria.

Second, fiscal policies to stimulate current activity should also address the longer term problems in the economy. Investments in infrastructure and public works, for example, have contributions to make in both a structural and a cyclical context. Such spending creates productive assets as well as current income.

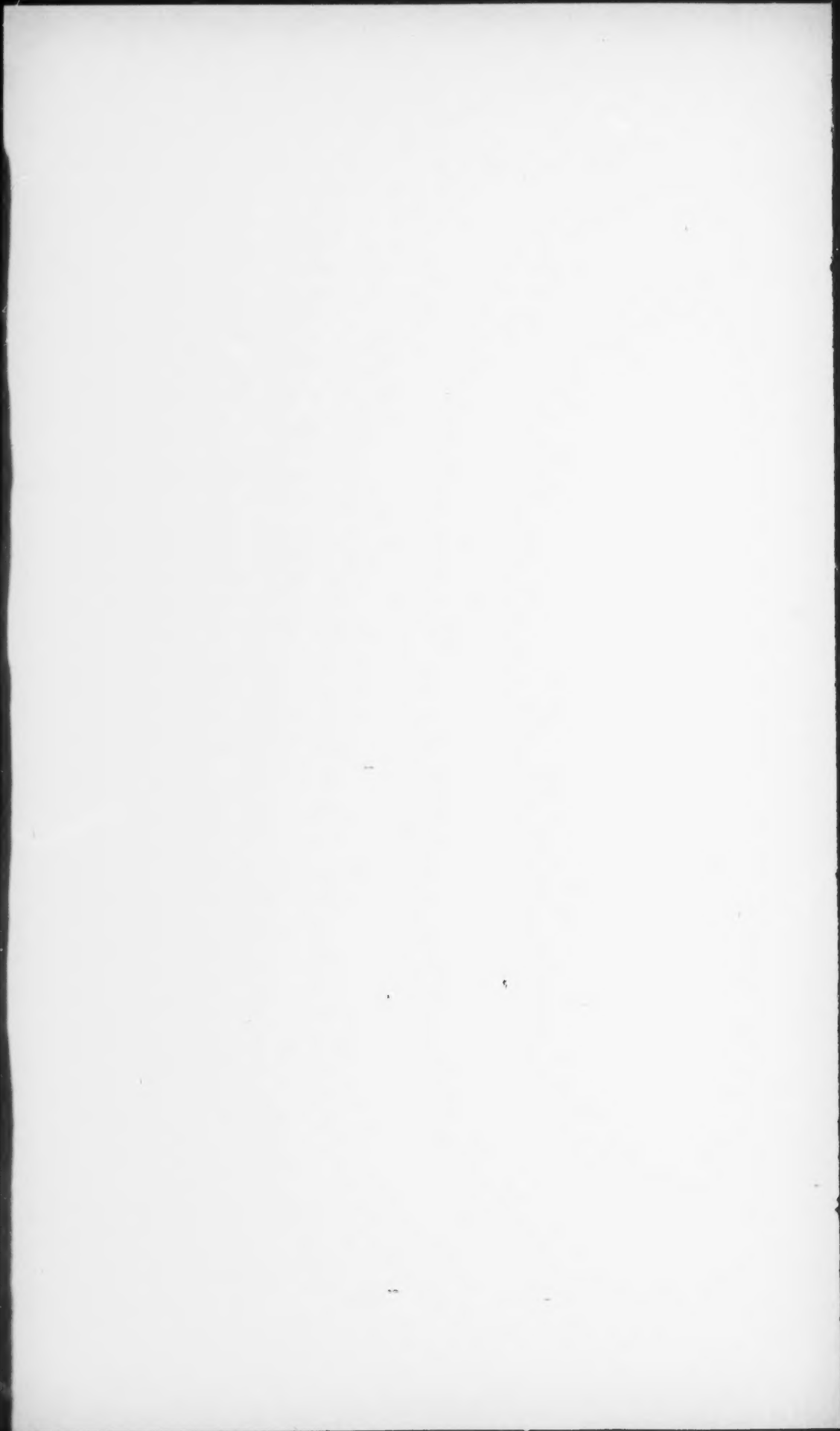
Repairing the Nation's crumbling bridges and improving the highways creates jobs and incomes now for construction workers and contractors. But such investment also improves our long-term productivity by complementing the productivity of private investment. Budget deficits are harmful when they drain current saving and place a burden on future generations. Productive public investment, in contrast, represents direct public saving that boosts future income.

In a later section of this *Report*, the Committee will examine in depth the problem of inadequate infrastructure spending. To reverse the pattern of neglect in this area, we make three recommendations:

- First, we believe that projects already approved and in the budget should be accelerated so that work is begun immediately. This would have a countercyclical effect without affecting the budget deficit.
- Second, we believe that monies already appropriated to infrastructure trust funds should be put to work on high-priority projects. Locking the funds away in the trust funds only helps disguise the true size of the deficit; it does not meet the needs of the country for an adequate infrastructure.

- Finally, over the longer term, we believe it appropriate to consider developing a public corporation along the lines of the Federal National Mortgage Association to facilitate the flow of capital into necessary infrastructure projects.

Combined with a more stimulative monetary policy, we believe these changes in fiscal policy could make a strong positive contribution to bringing the country out of the current recession.



BEYOND THE RECESSION: LONG-TERM TRENDS IN THE U.S. ECONOMY

While the focus is now on coming out of the recession, simply getting the economy moving forward again may not be good enough. The slow growth of the 1980s brought no appreciable increase in the material standard of living for the majority of Americans, and a recovery that merely takes us back to slow growth could well produce a disappointing, and for many of our people, a difficult decade of the 1990s.

To produce a more satisfactory pattern of growth in the 1990s, the country needs to come to grips with its disappointing pattern of productivity improvement.

PRODUCTIVITY GROWTH AND THE STANDARD OF LIVING

Discussions of economic growth often focus on how fast the overall economy is expanding. Certainly, the sheer size of the American economy contributes greatly to our military, diplomatic, and economic power in the world. And for that reason, growth in total output matters. But the standard of living of the average American depends far more on how fast output is expanding relative to population or work effort.

This distinction between growth in output and growth in our standard of living is illustrated in Table 1. The first three columns decompose growth in output for various subperiods since the end of World War II into growth attributable to greater work effort (hours), and growth attributable to greater productivity (output per hour). From 1948 to 1973, growth in output was fueled primarily by productivity growth, with a secondary boost from labor force growth. After 1973, productivity growth fell off sharply but labor force growth continued to support a reasonably healthy rate of growth of output. The impact of slower productivity growth is evident, however, in the later columns of Table 1, which reveal a slowdown in the rate of growth of per capita income, family income, and compensation per hour associated with the slowdown in the rate of growth of productivity.

Table 1
AVERAGE ANNUAL GROWTH IN PRODUCTIVITY
AND
MEASURES OF THE STANDARD OF LIVING

Period	Output	Hours	Output per Hour	Output per Capita	Average Family Income	Compensation per Hour
1948-73	3.6	0.6	3.0	2.2	2.9	3.2
1973-79	2.5	1.7	0.8	1.5	1.2	1.3
1979-90	2.6	1.5	1.1	1.4	1.1	0.1

Notes: Rates of growth of output, hours, and compensation per hour are calculated for the business sector from BLS indexes; output per capita is real GNP divided by population; average family income is from CBO and is available only through 1989.

Between 1948 and 1973, average wages and family incomes approximately doubled, and most families and workers shared in these gains. Had such growth continued after 1973, today's wages and incomes would be about 40 percent higher than they are. In fact, average hourly compensation is only about 15 percent higher than it was in 1973, and most workers have not shared in the gains that have occurred. Production and non-supervisory workers--the bulk of the labor force--have seen no real gains since 1973; what gains there were have been concentrated among managers and white collar workers.

Productivity growth was better in the 1980s than in the 1970s, but the unfavorable patterns of the 1970s persisted. During the expansion, the economy provided jobs for most workers who have sought employment. More workers worked more hours, hence total output and employment expanded. But most workers saw little increase in the purchasing power of their paychecks.

Clearly, productivity growth is the key to a higher material standard of living. True, we can have more output if a larger fraction of the population works longer hours. Without capital investment, technological progress or improved skills of the work force, however, increased work effort yields diminishing gains in output and correspondingly slower growth in wages and income. Moreover, increased work effort comes at the expense of non-market activities like nurturing children. More goods and services and greater time for non-market activities are hallmarks of a rising standard of living, but they are achievable only through productivity growth.

A healthy rate of productivity growth can also make a contribution to improving the distribution of income. From the end of World War II through the 1960s, strong productivity growth was associated not only with strong growth in the incomes of families at all levels of the income distribution, but also with relatively stronger growth for those with lower incomes. For the last two decades, however, slower growth in productivity and our average standard of living has hit those at the bottom harder.

Some of the factors contributing to the productivity slowdown would also appear to be contributing to growing inequality, especially those relating to worker education and training. During the 1970s, the labor force swelled with the entrance of the baby boom, a large group of young, and therefore relatively inexperienced, workers earning relatively low incomes. Unfortunately, incomes continued to become more unequal as the baby-boom moved into its later, and presumably higher-earning, years. Just as troubling, today's young workers are fewer in number, but they are not experiencing better incomes than those a decade ago.

ASSETS: THE KEY TO PRODUCTIVITY GROWTH

Getting productivity growing again is essential to improving individual and family living standards. But accomplishing this task will require substantial changes in the way we do things. Productivity growth in an economy is determined largely by the stock of productive assets that firms and individuals in the economy use to produce goods and services.

In economic terms, "assets" are the machinery, technical knowledge, human skills, and the physical and informational infrastructure that enable workers to produce more goods and services in each hour of labor. The faster the rate of growth in the stock of assets, all other things being equal, the faster the rate of growth in productivity.

The process of asset creation involves shifting the allocation of current income from current consumption to the creation of assets that will generate income (and consumption) in the future. Expanded asset creation thus requires a shift in orientation from the present toward the future.

Throughout the 1980s, the American economy in the aggregate followed a different path, one that emphasized the present over the future, and the creation of liabilities over the creation of assets.

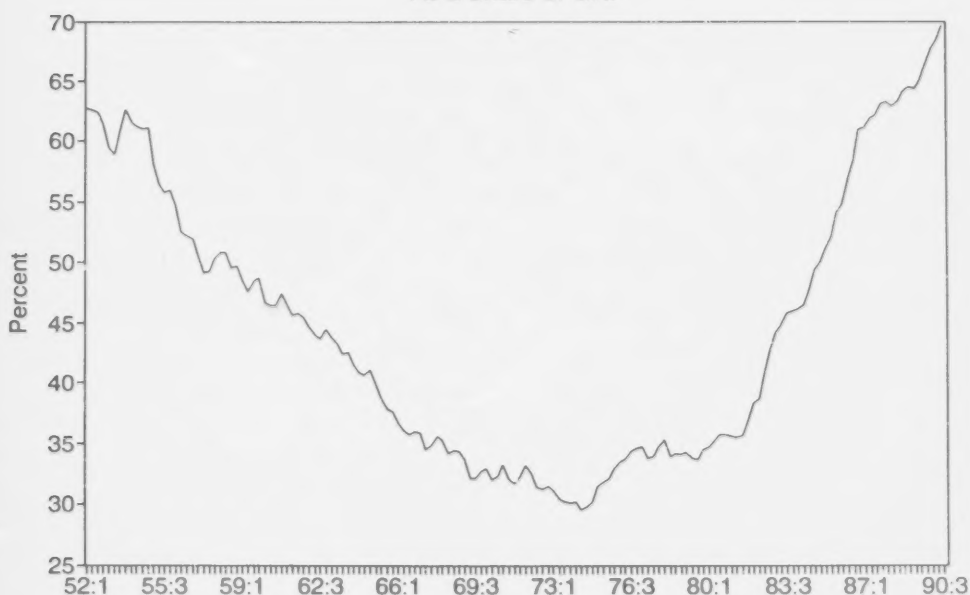
On company balance sheets, liabilities include all claims on the future output of the firm, be they obligations to pay bankers (loans), obligations to pay bondholders, or obligations to pay benefits to retirees. These claims

must be satisfied before the firm can distribute earnings to stockholders or make funds available for investment.

On the national balance sheet, our liabilities principally consist of private claims owed to foreign investors (net private external debt), and claims owed by taxpayers to fund past increases in the Federal debt (some of which is also owed to foreigners). Figure 3 on page 10 showed the enormous increase in our total net external debt. The earnings to be paid on these foreign holdings of stocks, bonds, and real estate constitute an ongoing burden on the future incomes of Americans. Figure 18 shows the massive federal debt growth from the fiscal deficits of the 1980s, which were an engine behind much of the accumulation of external debt. On the national balance sheet, our liabilities principally consist of claims owed to foreign investors (net external debt), and claims owed by taxpayers to fund past increases in the federal debt.

These claims against future income will need to be satisfied before firms and workers can enjoy the fruits of their labors. If the massive buildup of liabilities had been used to fund asset creation, the burden of the claims

Figure 18
Debt of the Federal Government
As a Share of GNP



Sources: Federal Reserve Board, Flow of Funds Accounts; Department of Commerce.

in the future might not be severe, since asset growth would increase the capacity of the economy to produce in the future.

Physical Capital

Investment in "hardware"--factories, equipment, machinery--is the component of asset creation most easily measured. By most accounts, the rate of investment in physical capital makes an important contribution to the rate of growth in productivity. Regretably, recent American performance in physical capital investment is clearly disappointing.

Figure 19 shows the deterioration of private domestic investment since the last cyclical peak. It shows that private investment (net of depreciation) has fallen as a share of net output when compared with the 1973-81 period. Despite the economic troubles of that period, it would seem that we faced those difficulties by attempting to provide for better times ahead. In the most recent period, by contrast, we failed to use the relatively benign eco-

Figure 19

Net Nonresidential Investment As a Share of Net National Product



Source: Department of Commerce, National Income and Product Accounts.

conomic climate to ensure that we would be well equipped to face future problems that might arise.

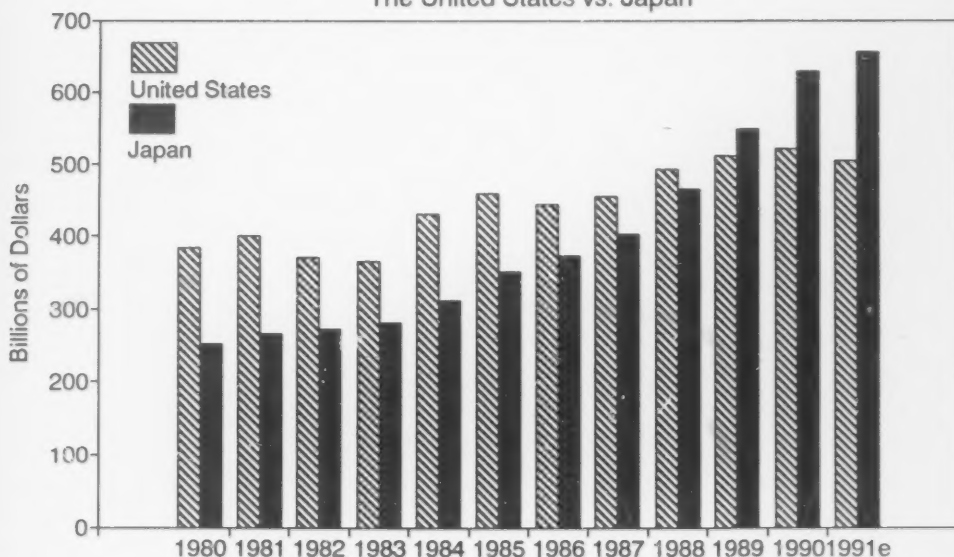
The declining trend in equipment investment is particularly problematic for our long-term growth prospects. A new study by two Harvard economists, J. Bradford De Long and Lawrence H. Summers, finds a strong link between investment in durable equipment and national economic growth: each 1 percent of gross domestic product (GDP) invested in equipment causes GDP to increase by one-third of a percentage point per year. This is a much stronger association than that between economic growth and any other component of investment, according to the study.

Data Resources, Inc.'s international comparisons of spending on capital goods show dramatically just how poor our performance is. In 1989, for the first, Japan outspent the United States in plant and equipment. DRI estimates that Japan spent \$628 billion on capital goods in 1990, compared to \$520 billion for the United States. That is particularly striking because Japan's population is only half ours and its GNP is only 60 percent of our own. This "capital investment gap" has grown steadily and is projected to reach \$150 billion in 1991 (see Figure 20).

Figure 20

Investment in Plant and Equipment

The United States vs. Japan



Sources: Data Resources, Inc.; Japan Economic Planning Agency through the Bank of Japan; and U.S. Department of Commerce.

e = Estimate.

As a result of much higher capital spending levels, the level of technological modernization in Japanese firms is significantly higher than among U.S. firms. Japan now uses numerically controlled machine tools at 1.5 times the U.S. rate: 27 per thousand manufacturing workers, compared with 18 per thousand workers in the United States. Japan also uses about seven times as many industrial robots per thousand workers as does the United States. Ninety-three percent of Japanese steel is continuously cast; the comparable figure for the United States is 60 percent.

Few countries are investing at the level of Japan, but several other countries have rates of investment in equipment that are significantly higher than our own.

Two other trends are central to the story of capital investment. First, underinvestment is most acute among small and mid-sized manufacturing firms--those with fewer than 500 workers. There are about 355,000 of these smaller firms in the United States, and they account for more than half of value added in manufacturing. A recent survey by the U.S. Bureau of the Census asked nearly 10,000 firms in five industries about their use of 17 advanced manufacturing technologies. In all 17 areas, larger firms (those with more than 500 employees) had higher technology adoption rates than smaller firms.

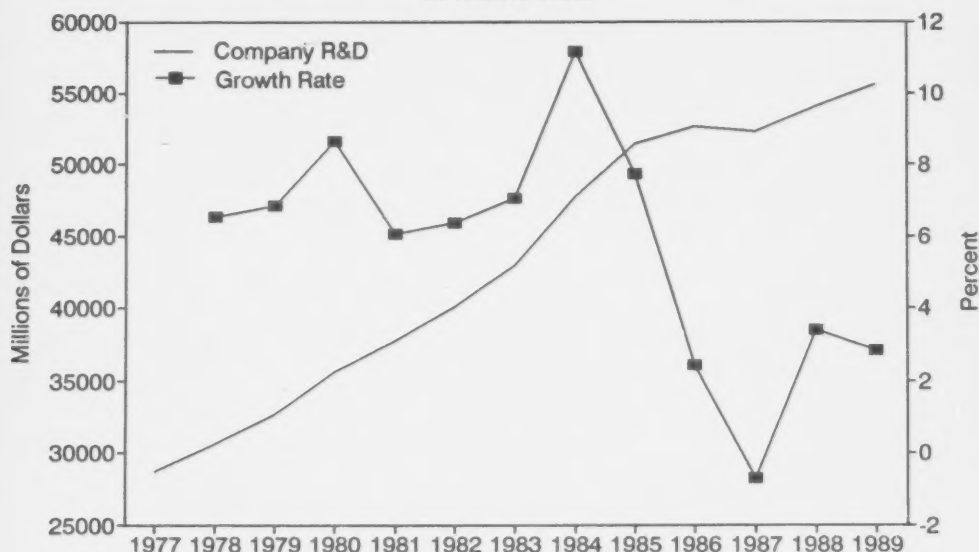
Second, the problem is not limited to underinvestment in capital. U.S. manufacturing firms have also lagged behind foreign competitors in design, quality control, shop floor organization, inventory management, and work force training. This means that even when a firm invests in equipment, the equipment is not used to full potential. For example, using similar flexible manufacturing systems, U.S. firms produce a less varied mix of parts, make fewer parts per day, introduce fewer new parts, and have less machine up-time than comparable Japanese firms.

Research and Development

Physical capital assets derive much of their productive value from the fact that they embody new knowledge about how to produce things more efficiently. But knowledge--intellectual capital--can also improve the productivity of enterprises without being embedded in new physical capital. A rough measure of the country's investment in intellectual capital can be found in statistics on research and development expenditures.

U.S. corporate investment in R&D has grown by only 3 percent per year since 1985 (see Figure 21). This slowdown notwithstanding, U.S. industry's competitive problems have much less to do with the sheer level of investment in R&D than with the allocation of that investment. Spending

Figure 21
Company Funded Research and Development Funds
 In 1982 Dollars



Source: National Science Foundation.

is oriented to making technological "breakthroughs" at the expense of the incremental innovations necessary to "follow through" on those new discoveries. This trend is particularly apparent in three areas:

Neglect of Process Technology. Economist Edwin Mansfield identified a striking contrast in a study of 50 matched pairs of U.S. and Japanese firms in six industries. U.S. firms devote about two-thirds of their R&D expenditures to improved product technology and about one-third to improved process technology. Among Japanese firms, the proportions are reversed, with two-thirds going for process technology and only one-third for product technology. American firms invest 17 percent of their innovation funds in "marketing," while their Japanese counterparts invest less than half as much (8 percent).¹

¹ Edward Mansfield, "Industrial Innovation in Japan and the United States," *Science*, Vol. 241, September 1988.

Separation of R&D from Production. Process innovations are more likely to come from the factory floor than the R&D lab, yet current U.S. practice has moved R&D from the factory floor to campus-like settings far removed both geographically and culturally from the production site. This "assembly-line" approach to innovation has undermined manufacturing, as Richard Florida and Martin Kenney describe:

As this process moved along, projects and products would simply be passed over the transom from R&D to product development, from product development to pilot production, and from pilot production to manufacturing. Once a project was handed on, the receiving group was confronted with a *fait accompli*, their freedom of operation constrained by earlier decisions. Each group optimized according to its own situation and not on the basis of the entire product. Delays and redesign at each stage were common. It typically took a very long time to complete this process, and the complexity added by each stage often made the end products very difficult to manufacture. ("The Break-through Illusion," *Basic Books*, 1990).

Here again the contrast to Japan is striking. According to a recent study by William Finan and Jeffrey Frey, major Japanese semiconductor firms without exception rotate their scientists and engineers from the lab to the factory, as a way to transfer technology into production.² This close interface between design and production allows Japanese firms to adapt foreign products to domestic requirements and quickly lower production costs. According to Mansfield's study, Japanese firms are able to commercialize technologies that originate outside the company much more quickly and cheaply than American firms.

The separation of R&D and production in American firms has also led to an estrangement of research from corporate management. According to one account, "R&D came increasingly to be viewed as an expensive but necessary gamble, in which the costs of countless losses could be covered by one big 'home run'." Corporate scientists often prefer the home-run strategy for their own reasons, and the result is an R&D operation that rewards the occasional blazing discovery over steady contribution to product improvement.

This home-run mindset shows up in comparative R&D figures: U.S. firms spend far more than their Japanese counterparts on R&D for entirely new products and processes, and far less on incremental changes in existing

² Finan, William F., and Jeffrey Frey, "The Effectiveness of the Japanese Research-Development Commercialization Cycle: Engineering and Technology Transfer in Japan's Semiconductor Industry," a report to the Semiconductor Research Corporation, August 1989.

products and processes, according to Mansfield. It shows up as well in the continuing failure of American companies to systematically monitor and exploit technology developed elsewhere.

Underinvestment in Risky, Long-Term Development. Ironically, even when American R&D labs hit home runs--and there have been many--managers have often been unwilling to make the long-term commitment to turning technology into product. An RCA scientist discovered liquid crystal displays in 1964, but the company quickly gave up commercialization efforts because of the threat to existing products. Several large American companies, including IBM, AT&T and General Electric, had flat-panel display operations in the 1980s, but sold them or closed them when the market did not seem to be materializing. Today, LCD technology is the basis of an exploding market for flat panel display screens, and the American firms that abandoned the technology years ago are today buying flat panels from Japanese competitors because there are virtually no American producers.

High-temperature superconductivity (HTS) provides yet another example. Last year, the Office of Technology Assessment concluded that the United States had the world's most advanced research program on HTS, but warned, "there is a serious question as to whether U.S. companies have the staying power to capitalize on it."

OTA's study revealed that Japanese firms had invested 50 percent more in HTS R&D (\$107 million) than U.S. firms (\$74 million) in 1988, and their investment in low-temperature superconductivity (LTS) R&D was three times larger. Japan's greater investment in low-temperature superconductivity is also notable because it reflects the country's product orientation. Whereas most HTS R&D is still in the lab, work on LTS is largely engineering development. Characteristically, Japanese firms are moving quickly to make product, on the theory that the lessons from commercializing LTS will apply to HTS.

Human Capital

Finally, productivity growth can be improved by making investments in the education and skills of the work force. There is a growing body of opinion that holds that such investment in "human capital" may actually be more important to productivity growth than investments in either physical or intellectual capital.

As several recent reports have emphasized, maintaining and elevating American living standards and wage levels cannot be done by a low-skill economy with a repertoire of standard, aging industries.³

Unfortunately, the promise of increased productivity held out by these and other studies is not being realized in today's economy.

A society's investment in human capital starts with the family. The skills and abilities embodied in individuals are acquired as a result of investments (foregone consumption) of time and money by the individuals themselves and other family members. A vital part of preparation for further learning takes place in the home during a child's earliest years. The quality and quantity of this preparation, and the support received during years of formal schooling, is closely related to future capacities to grow and learn in the work place.

Yet, recent economic trends have taken a heavy toll on many American families. Nearly one-quarter of all children in 1988 lived in families classified as poor, up from 16.6 percent in 1968. Our inadequate health-care system leaves some 35 million Americans without access to basic health care, contributing to health problems such as low birth weights, lack of prenatal and postnatal preventive care, and less frequent immunizations against common childhood diseases. These health problems have repeatedly been shown to impair a child's ability to learn.

The struggle of an increasing number of families to make ends meet by working longer or putting more family members into the labor force is also taking its toll on human capital creation at home. Time and energy available for supervising schoolwork can only have been reduced by pressures to put more family hours into paid work. Lack of parental interest and support was cited by a higher percentage of teachers as a major problem for public schools than any other factor--31 percent in 1984 and 34 percent in 1989.

At the elementary and secondary levels, the performance of American schools clearly leaves much room for improvement. A rising tide of reports and monographs has found fault with the performance of U.S. schools and students. A major indictment of the system is the assertion by many employers that young workers are not well prepared for employment, and perhaps even more crucial from the point of view of productivity growth, are not well-prepared to learn more. In particular, so called "higher order" skills

³ Office of Technology Assessment, *Competing in the New International Economy* (1990); Commission on the Skills of the American Work Force, *America's Choice: High Skills or Low Wages* (1990); Secretary of Labor's Commission on Work Force Quality, *Investing in People: A Strategy to Address America's Work Force Crisis* (1989).

relating to structuring and solving problems in new and ambiguous situations are not well-developed in the American work force. These skills are particularly needed as the useful lifetime of products and processes shortens, and as workers increasingly need to interact with each other and with customers.

Beyond high school, Americans are finding it progressively more difficult to finance the college educations that are needed for tomorrow's work force. Costs for post-secondary education are rising much faster than the incomes of the overwhelming majority of American households. One index of this cost pressure is to look at tuition, room and board for one college student as a percentage of the income of families with school-age children. In 1979, such a family with the median income for its type would have paid 9.7 percent of its income at the average public institution and 22.1 percent at the average private institution. By 1987, these percentages rose to 12.0 percent at public and 31.3 percent at private institutions for median income families receiving no grants or loans. For poorer families, the percentages obviously would be much higher.

As a Nation, we are not delivering on the commitment expressed in the Higher Education Act of 1965, that a qualified student will be able to attend college. The percentage of those 25-29 year olds having completed four or more years of college rose about 10 percentage points, to 28 percent, between 1965 and 1977. Since then, the rate has fluctuated just above 25 percent.

Firms also make investments in the human capital of their workers, but not on the scale required for the needs of a high-productivity economy. Although the Congressional Office of Technology Assessment concluded that firms spend in the range of \$30-\$44 billion per year, this year's *Economic Report of the President* argues that \$20 billion of that total is spent on remedial training to make up for deficits in basic skills.

The most recent comprehensive look at employer commitments to human capital creation was the report of the Commission on the *Skills of the American Work Force*. The study found that only 5 percent of firms surveyed were attempting to devise substantial programs to augment the human capital of their workers.

The interaction of recent developments in families, schools, and work places creates an uncomfortable assessment of our recent achievements in the area of human capital development. Dr. Marc Tucker summarized the findings of the bipartisan Commission on the Skills of the American Work Force in the following terms:

From birth to the end of their working lives, we invest less in our blue collar work force than any of the major countries with which we compete. We give them less care when they are infants and children. We expect less of them in school. We give them less job training when they start out. We let them sink or swim when they try to get into the work force. And we provide them with less training once they are at work.

PUBLIC SUPPORT FOR ASSET-CREATION

Clearly, the current pace of asset creation in the economy is not adequate to provide the basis for a sustained future rise in either the productivity of our economy or the standard of living of our people. Changing the American approach toward asset creation must be done largely in the private sector, since it is households and firms that undertake the overwhelming majority of investment activities in the economy.

Governments at all levels also have important roles to play if the economy is to sustain a pace of asset-creation compatible with adequate rates of productivity growth. Governments have a major responsibility for the creation of human capital through primary and secondary education, for the creation of knowledge in basic science, and for the creation of the infrastructure that facilitates private economic activity. The Federal Government also has the additional responsibility of creating an overall economic climate conducive to asset-creating activities by private households and firms.

During the 1980s, however, governments at all levels have pulled back from their responsibilities in the area of asset creation. Direct investment in infrastructure has fallen steadily, and federal policies have contributed to an overall economic climate, which has made it less attractive to create assets in the private sector.

DIRECT INVESTMENT IN INFRASTRUCTURE

Although increased private investment will be required to improve productivity and living standards, the private sector cannot move the economy upward alone. To keep the United States competitive and provide decent jobs and incomes in the years ahead, investment and entrepreneurship by American industry must be combined with the firm foundation of an adequate and efficient public infrastructure.

The Nation's public infrastructure includes its roads and bridges, water and sewer systems, waste removal systems, schools, airports and air traffic control systems, canals and harbors, mass transit systems, and public health and safety systems. These investments cannot be provided adequately by the private sector alone: either their services are not marketable or

private investments have inadequate incentives to invest at appropriate levels. For example, relying primarily on the market to provide roads and bridges, by allowing roadbuilders to collect tolls, would be cumbersome and expensive; it would impede rather than facilitate transportation and the movement of goods and people.

For its investment in infrastructure, the Nation gets a more productive economy as well as many benefits that directly enhance the quality of life. Public roads, bridges and highways form the Nation's primary source of transportation, linking families with work, school and shopping, as well as one part of the country with another. Public water and sewer systems provide water to most of the Nation's households and remove wastes efficiently and sanitarily.

Equally important, public infrastructure contributes to the performance of the economy by making private capital and labor more productive. Public infrastructure is essential to a modern productive private sector. Much private capital would be diverted into infrastructure-type investments that would wastefully duplicate the efforts of other enterprises. If each firm had to provide its own water supply and waste disposal facilities or its own police and fire protection, the costs of goods and services would be increased immeasurably. Our productivity and standard of living would be much lower.

Recent studies have found that public capital investment makes a significant contribution to national output, productivity, growth and international competitiveness.¹ Among industrial countries, a strong correlation exists between the fraction of GNP invested in public infrastructure and the long-term rate of productivity and economic growth. Within the United States, those states that have invested more in infrastructure tend to have greater output, more private investment and more employment growth.² Even at the metropolitan level, the stock of public capital has been found to make a positive and significant contribution to manufacturing output.³

¹ See Alicia H. Munnell, "Why Has Productivity Growth Declined? Productivity and Public Investment," in Federal Reserve Bank of Boston, *New England Economic Review*, January/February 1990, for a summary of the research and list of references.

² Alicia H. Munnell, "How Does Public Infrastructure Affect Regional Economic Performance?", Federal Reserve Bank of Boston, *New England Economic Review*, September/October 1990, pp. 11-32.

³ Randall W. Eberts, "Estimating the Contribution of Public Capital Stock to Metropolitan Manufacturing Production," Federal Reserve Bank of Cleveland, xerox, June 1988.

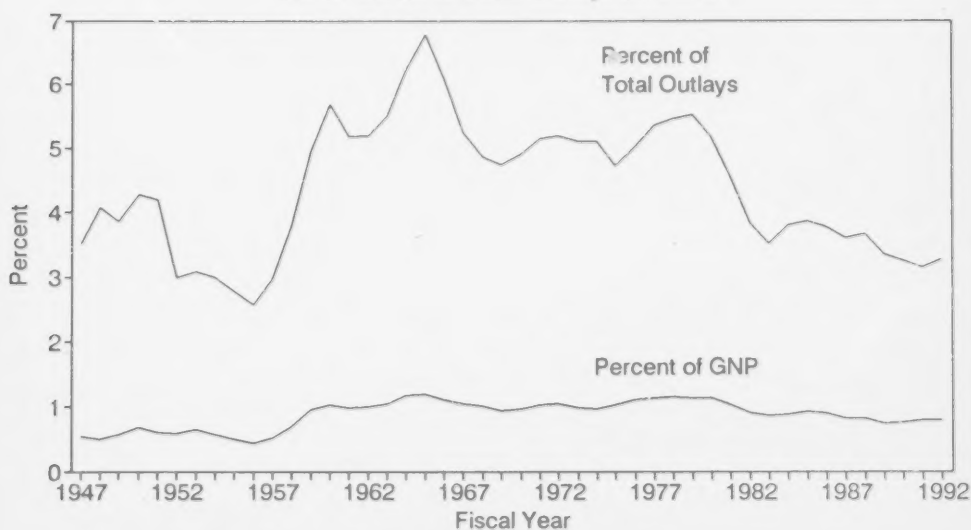
This research suggests that economic progress during the 1990s will depend at least in part on whether or not the Federal Government, as well as state and local governments, invest adequately in infrastructure. The record of the recent past is not promising.

Starting in the early 1970s, federal spending on infrastructure assets has been declining, whether measured as a fraction of total federal outlays or as a fraction of gross national product (see Figure 22). A brief increase following the 1981-82 recession was reversed by later cuts in federal grants to the states and by budget pressures resulting from the weakening of the economy since 1988. The current recession, causing large deficits in many state and municipal budgets, will lead to more cuts in 1991 and 1992.

Despite the economic importance of an adequate infrastructure, the Reagan and Bush Administrations have sought to shift responsibility for infrastructure investment out of the federal budget onto state and local governments. During the 1980s, federal grants-in-aid to state and local governments for infrastructure fell by half, as shown in Figure 23. The

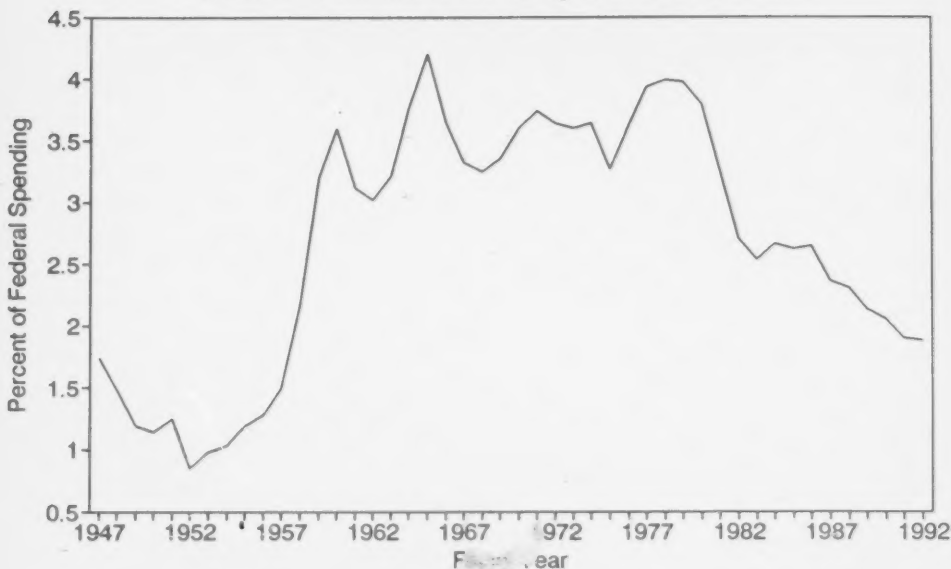
Figure 22

Federal Infrastructure Outlays As a Percent of Total Outlays and GNP



Source: *Budget of the United States Government, Fiscal Year 1992*, historical tables.

Figure 23

Federal Grants for Capital Investment

Source: *Budget of the United States Government, Fiscal Year 1992*, historical tables.

largest cuts, both in real terms and as a percent of total outlays, occurred in community development and pollution control programs, but significant cuts were also made in federal highway aid and aid to mass transit systems. The Bush Administration's transportation plan seeks to continue this process by shifting even more of the responsibility for funding infrastructure from the Federal Government to state and local governments.

This approach to public investment spending during the 1980s has taken its toll on the quality of U.S. infrastructure. The Federal Highway Administration has found that structural deficiencies affect the safety of 23 percent of the Nation's 575,000 highway bridges, while another 19 percent are obsolete. According to the General Accounting Office, urban traffic congestion will rise 300 percent by the year 2005, wasting 7.3 billion gallons of gasoline and costing commuters as much as \$50 billion annually. Hearings before the Joint Economic Committee during the late 1980s found that underinvestment in the air traffic control system had reduced the margin of safety in the Nation's air transportation system.

In older central cities in the Northeast and Midwest, an aging infrastructure is contributing to an urban decay that feeds upon itself. As the

infrastructure deteriorates, businesses and residents leave, which erodes the tax base and leads to a further deterioration of the infrastructure and an endless downward spiral. In other parts of the country--high-growth areas of the South and West and many suburban rings around older cities--population and business growth are putting increasing strains on local water and sewer systems, roads are becoming more congested, landfills and toxic waste dumps are becoming increasingly saturated. The U.S. Department of Commerce estimates that infrastructure use by industry alone will grow 30 percent during the next decade as the result of economic growth, the dispersion of population and economic activity, and technological change.⁴

The effect of the decline in public investment on the private sector can be seen in Figure 24. A healthy economy would experience a rising value of capital per worker in both the public and private sectors. Instead, public capital per worker peaked in the mid-1970s, and has declined steadily since. This has caused the public/private capital ratio to fall dramatically and steadily for the past two decades.

Recent research suggests that the decline in public investment has been a major factor in the productivity decline that began in the early 1970s, and has thus been a major reason why the United States has lost its competitive position in the world economy. Inadequate infrastructure has also been linked to the depressed profitability of private industry in recent years and to the low rate of net private investment since the early 1980s.

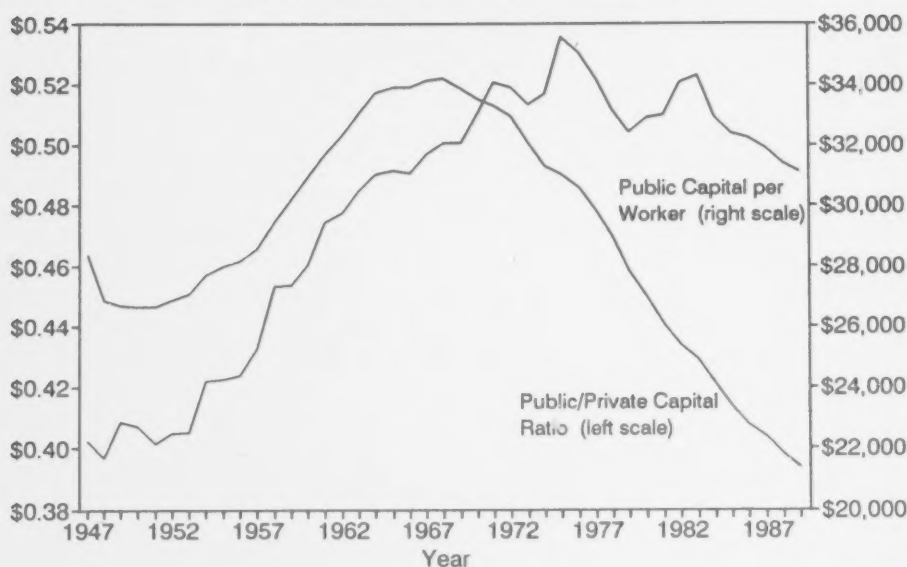
A growing body of research suggests that the current unwillingness to invest in public infrastructure will hurt our future economic growth and prosperity:

- A study conducted in 1985 by the Joint Economic Committee concluded that we need to invest almost \$65 billion per year (in 1982 dollars) just on highways and bridges, other forms of transportation, and water and wastewater systems during the 1990s, almost 50 percent more than the nation was spending on these items at the time.

⁴ National Council on Public Works Improvement, *Fragile Foundations: A Report on America's Public Works, Final Report to the President and Congress*, 1988, p. 10.

Figure 24

Public Capital Per Dollar of Private Capital and Per Private Worker, in 1982 Dollars



Source: U.S. Department of Commerce.

- The National Council for Public Works Improvement determined in 1988 that annual real capital spending over the next decade for all new and existing public works should be more than \$90 billion per year. By comparison, it calculated that the 1985 level of investment in comparable activities was only \$45 billion.
- At a recent Joint Economic Committee hearing on public investment in human and physical infrastructure, Nobel-laureate economist James Tobin of Yale and Alan Blinder of Princeton presented a statement signed by 327 economists calling for increased investment by the Federal Government in both human and physical infrastructure. The statement argued that "America faces a 'third deficit'--the deficiency of public investment in our people and our economic infrastructure."

Most economists believe that our long-term prosperity and competitiveness will require a substantial increase in public infrastructure investment. Funding for much of this will have to come from state and local governments through higher user fees and higher taxes. But the Federal

Government will have to do more as well, to assure an overall public capital stock adequate to meet the needs of a growing national economy.

In principle, the federal share could come from existing resources and savings elsewhere in the budget. One important source is the dedicated trust funds. By the end of FY91, the airport and airway trust fund will have accumulated an unexpended balance of \$15.3 billion, while the highway trust fund will have an unexpended balance of \$18.9 billion. These trust funds could be spent at a substantially faster rate than the Administration has proposed. But these trust funds address only part of the infrastructure shortfall. Funding for other forms of infrastructure--dams, harbors, water and sewer systems, among others--is not now provided from dedicated trust funds, yet may be equally important to the Nation's economic health.

For the long run, a permanent source of funding would offer a better match between public capital spending and the Nation's infrastructure needs. One option that we believe deserves close consideration would be to create an independent public Infrastructure Bank, which would do for state and local capital spending what Fannie Mae did for homeownership. The bank would be allowed to raise capital periodically by issuing bonds at or near the Treasury rate through the Federal Financing Bank, the proceeds from which would be loaned to state and local governments at preferential rates for designated capital investments. As principal and interest are paid on the loans, the investment fund would be replenished. The Federal Government's contribution would be the interest rate subsidy, which could vary according to the nature of the investment or the importance of the investment to the national, as opposed to local, economy, as well as the proportion of the investment paid from state or local funds.

INVESTING IN PEOPLE

The previous chapter of this *Report* made the case that the American economy urgently needs a well-trained and highly-productive work force, yet families, schools and businesses are failing to undertake investments in people on the scale needed to realize this objective.

Education is largely a responsibility of state and local governments. The Federal Government needs to support those critical activities that are beyond the means of local governments as well as to support the process of educational change at the local level.

The starting point for federal involvement should be early childhood programs. Due to current funding limitations, only about 20 percent of those eligible for Head Start are enrolled in the program, despite ample evidence

that this program makes a major difference in the lives of its participants. We believe that efforts should be made to push that percentage upward.

A second major goal is to reduce the school dropout rate significantly. One out of every four high school students drops out today, yet there are local programs around the country that have proven themselves effective at preventing dropouts. We believe that the Federal Government should identify and highlight these programs as part of a national effort to bring our dropout rates down substantially.

A third objective is to create a more attractive environment for teachers. A number of studies have estimated that we will need about 2 million new teachers before the year 2000, yet some 20 percent of new teachers leave the profession during their first year on the job. The Federal Government should take the initiative in increasing the prestige associated with teaching, as well as increasing the support for teacher education.

A fourth area for federal involvement concerns evaluation. Before any organization, including a school, can improve performance, there needs to be a reliable mechanism in place for assessing "improvement." Yet, today's methods for evaluating both teaching and learning are inadequate to the task of assessment.

Standardized, multiple-choice tests do a particularly bad job of measuring the kinds of cognitive and social skills needed to function well in a technology-intensive workplace. Rather than trials undergone in isolation, assessments should identify areas for needed improvement and certify mastery of particular skills.

The same principle holds for the assessment of teaching, where new instruments are clearly needed before the country can give concrete meaning to the new emphasis on "excellence" in teaching. Yet, despite the importance of teacher assessment, the Bush Administration last year opposed passage of legislation that would have created a National Board for Professional Teaching Standards, whose principal goal was to improve the quality of teacher assessment in this country. We believe such legislation is necessary and should be enacted as soon as possible.

Finally, the Federal Government needs to play an active role in promoting a pattern of more effective school-to-work transition. School interactions with employers in this country are considerably less extensive and intensive than they are in some of our major competitors, such as Germany and Japan. In West Germany, about 70 percent of non-college going students entered apprenticeships at the conclusion of their formal school. In Japan, as outlined in testimony to the JEC by Professor Ronald

Dore, the connection between schools and employers is particularly close, and students are aware that their lifetime job chances are heavily influenced by their high school record and teacher recommendations.

In the United States, by contrast, there is very little connection between high school achievement and later labor market success for those not entering college. The diploma is regarded as evidence of motivation or staying power, but firms almost never obtain information from an applicant's school on his or her achievements.

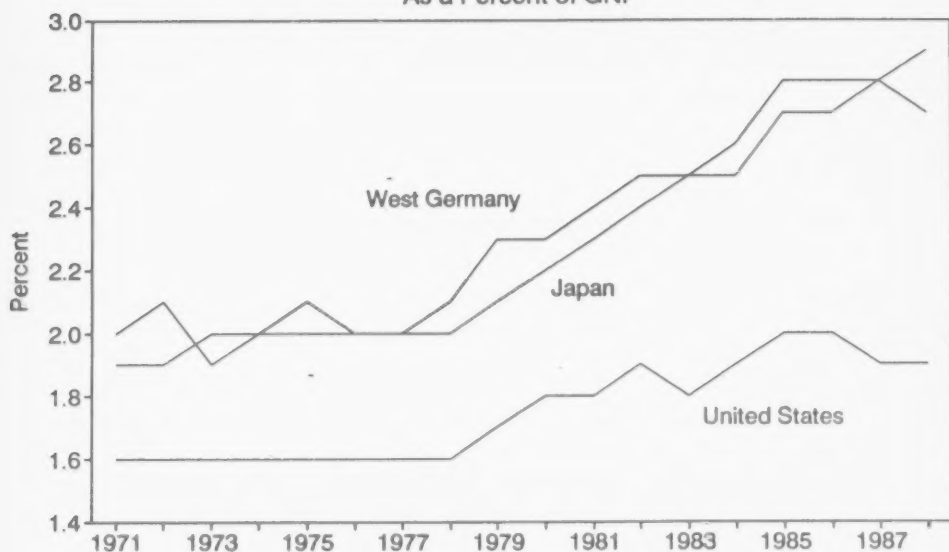
We believe that our current pattern puts American firms at a disadvantage in hiring and training workers. We therefore support the creation of a national apprenticeship program to improve the school-to-work transition.

INVESTING IN IDEAS: SCIENCE AND TECHNOLOGY POLICY

Public investment is also required to generate new knowledge. Yet, Figure 25 shows that the United States continues to spend a far smaller percentage of its GNP on civilian R&D than our major competitors. Before 1980, federal R&D expenditures were divided roughly 50-50 between military and civilian programs. Heavy emphasis in the 1980s on defense spending skewed that ratio to roughly 70-30. Although the pattern has begun to shift back, military programs still account for more than 60 percent of federal R&D. Because of drastic budget cuts earlier in the 1980s, 1991 is the first year civilian R&D spending has exceeded its 1979 level in constant dollars. Even with the modest increases in the current budget, spending on civilian R&D remains below the levels reached in the late 1960s.

The consequences of shortchanging civilian research and development can be seen in the results of a new study by the Commerce Department of 12 emerging technologies that will be critical to future economic prosperity. The list includes such things as superconductors, biotechnology, optoelectronics, and high-performance computing. The study concludes that, in terms of trends (rather than current status) in world competition, the United States is "losing badly" to Japan in four of the 12 technologies, "losing" in six, "holding" in two, and "gaining" in none!

Figure 25
Nondefense Research and Development
As a Percent of GNP



Sources: National Science Foundation, SRS, and Organization for Economic Cooperation and Development.

The United States has made most of the major breakthroughs in electronics, yet Japan increasingly dominates that industry, largely by licensing or reverse-engineering our technology, and then developing it into products that are higher-quality and cheaper than anything made in the United States. The ease with which technological discoveries can be imitated gives the competitive advantage not to those who make the original discovery, but to those who perfect the manufacture of new products.

Technology policy abroad recognizes this reality. Japan focuses on training large numbers of engineers, and on speeding technology diffusion through cooperative R&D ventures and manufacturing extension services. Similarly, West Germany has an elaborate system of vocational education, a network of research centers that provides technical support to small- and medium-sized firms, and a well-developed system of industrial standards--all designed to promote engineering and manufacturing excellence.

By contrast, our own technology policy cultivates the scientific frontier, largely ignoring downstream issues of engineering and manufacturing. We believe that this orientation puts us at a competitive disadvantage,

and propose to change the thrust of our science and technology policy in four areas:

First, we must begin to support non-proprietary research in civilian engineering and manufacturing--areas such as measurement of materials and processes, production systems engineering, and design for manufacturability. Federal support for manufacturing research is currently less than 2 percent of total federal R&D, and nearly four-fifths of that is defense-related.

Recent Administrations have viewed support for civilian manufacturing and engineering as "industrial policy." But as IBM's former chief scientist Lewis Branscomb argues, the debate over appropriate roles for government investment should be framed as generic versus appropriable research, not as science versus engineering. To be sure, government must avoid simply replacing private dollars with public ones; but this can be accomplished by following the same criteria for engineering and manufacturing research that the National Science Foundation follows for science: namely, research that is timely; has high intellectual value, application potential, or both; and is unlikely to be funded adequately by industry.

Second, federal policy should promote the diffusion and adoption of existing scientific and technological knowledge, not just the creation of new knowledge. Proven approaches to technology diffusion--for example, manufacturing extension services geared to small and mid-sized firms--remain seriously underfunded. Total state and federal spending on manufacturing extension is about \$65 million a year. That pales in comparison to the Agricultural Extension Service--with its annual funding of more than \$1 billion (30 percent federal)--although agriculture constitutes a substantially smaller share of GNP than does manufacturing.

Our efforts also compare poorly to Japan's, where a nationwide network of kohsetsushi centers provides technology extension to smaller manufacturing firms. Japan has 170 of these centers with 7,000 employees and annual funding of \$500 million--10 times the U.S. effort. Despite this, the President's FY92 budget would eliminate funding for one of two manufacturing extension provisions of the Omnibus Trade and Competitiveness Act.

Third, we must provide greater support for generic commercial technology. Support should be twofold: (1) for long-term, high-risk R&D at precommercial stages, with the goal of making relatively dramatic advances in technology; and (2) for generic technology development, which would typically be incremental in nature. Experts disagree about what institutions can best provide such support--for example, a civilian technology

agency versus an expanded DARPA (Defense Advanced Research Projects Agency)--but a broader government role is needed.

Although the President has acknowledged the need to support generic technology development, there is almost no funding for it in his FY92 budget. Moreover, virtually every Congressional initiative put into DARPA's FY91 budget has been jettisoned, including X-ray lithography, high resolution displays, and \$50 million for precompetitive industry consortia in critical technologies.

Finally, we need to expand current efforts by U.S. industry and government to monitor and exploit foreign technology bases, particularly that of Japan. More than 5,000 Japanese scientists work in U.S. laboratories each year. By contrast, only a few hundred U.S. scientists work in Japanese labs, most only for a few months

INVESTING IN INFORMATION: THE PUBLIC STATISTICAL SYSTEM

A sound statistical infrastructure, like other forms of public investment, makes our Nation more productive and prosperous. Modern businesses make decisions based on government data in which hundreds of billions of dollars are at stake. Investment and production plans typically are premised on economic and demographic data provided by government. Cost-of-living adjustments for millions of workers are linked to official price indexes. Farmers decide what to plant on the basis of government estimates of agricultural production and sales.

The economic importance of federal statistics is not limited to "economic" statistics, narrowly defined. Health statistics have important economic implications given the large and growing share of our economy devoted to health care. The difficulties that uneducated workers have securing employment argues that education statistics also have important economic consequences. Data on the environment affect decisions about energy and ecology policy that have important economic consequences.

Statistical programs were frozen or cut during the 1980s, while the economy and the society at large changed dramatically. Economic activity increasingly shifted from manufacturing where physical products are easy to count, to services where output is difficult to measure. International trade became far more important to the economy, but our trade statistics never caught up. The financial system underwent a sea-change, but financial reporting was scaled back. Relationships between firms and sectors of the economy changed (e.g. greater reliance on out-sourcing), but our input-output tables remain stuck in the 1970s. The price of housing surged to the

point that it claimed about half of poor families' budgets, but poverty thresholds continued to be based on a 1960s' methodology based primarily on the cost of food.

Budget cuts over the past decade have forced statistical agencies increasingly to rely on "imputation" where collecting data is too expensive. This has been agencies' typical response to inadequate resources for tracking areas of rapid social change. Agencies have developed extremely sophisticated methods for making these imputations, thereby stretching the limited resources at their disposal. While this is commendable as far as it goes, there can be no substitute for real data.

Users of federal statistics often are unaware that published series rely so heavily on imputations, and are surprised when these series are later revised. This occurred last year when five-year budget deficit projections had to be revised by about \$100 billion after real data indicated that earlier imputations concerning wages and salaries were flawed. In those cases in which imputations are never checked against real data, the errors can get larger and larger.

The budgets of most statistical agencies were severely cut in inflation-adjusted terms in the early 1980s. In the latter part of the decade, some programs managed small increases. However, real spending for federal statistics in FY91 stands only about 1 percent above its FY80 level. In addition to tight budgets, surveys were cut back in a paperwork reduction effort primarily intended for regulatory agencies. Moreover, statistical programs also suffered from a political climate in the 1980s in which statistical information was not considered important to the development of imaginative policy.

The current Chairman of the Council of Economic Advisors, Dr. Michael Boskin, has committed his authority to the resuscitation of federal statistics. In testimony before the JEC this year and last, Dr. Boskin acknowledged that the quality of federal statistics had declined in absolute terms as well as relative to our changing needs. The Administration's FY91 budget proposal embodied these concerns with funding increases for selected programs, many of which the Congress passed. Chairman Boskin has followed up with more comprehensive proposals for FY92 and beyond.

The Committee strongly supports Dr. Boskin's initiatives in the statistical area. Without his leadership, progress on this important issue would have been much more difficult. While supporting his efforts, the Committee is concerned that the the Administration's statistics initiative does not fully meet the Nation's needs. The proposed budget increases will raise inflation-adjusted statistical funding only modestly above its level at the

beginning of the 1980s. The dramatic changes in our society in the last decade argue that funding should be expanded commensurately, rather than merely restored.

Also, the Boskin initiative remains largely limited to core economic statistics. Although Chairman Boskin has acknowledged before the Joint Economic Committee the importance of "non-economic" statistics, his initiatives have not provided for these concerns. In testimony this year, for example, he lamented the inadequacy of our output measures in the growing health sector. However, the Administration's FY92 budget proposal for the National Center for Health Statistics, which tracks health outcomes among other things, calls for a budget cut, even before accounting for inflation. The economic consequences (not too mention the non-economic consequences) of inadequate health, education and environmental statistics suggest that they should be included among Dr. Boskin's concerns.

The primary shortcoming of the Administration's statistics initiative is its limited scope. While we welcome and support the specific program improvements that the CEA Chairman has put forth, we would argue for a sustained, across-the-board effort to rehabilitate data collection throughout the government. This should be accompanied by initiatives to improve the coordination of statistical agencies' work so that they can realize economies of scope and avoid duplication. Furthermore, efforts to bring U.S. statistics into line with standard international practice should be expanded.

Clearly, a schedule of multi-year budget increases for all statistical agencies would allow sensible planning and provide for ongoing research into areas in which data are weak. Though we obviously are operating in times of budget restraint, we should also recognize that the cost of statistical programs is minuscule, accounting for less than one-tenth of 1 percent of federal spending. Statistics' cost is especially small compared to the hundreds of billions of dollars ventured on the presumption that federal data are reliable, or compared to the cost of addressing social problems after they have already become acute.

Furthermore, the FY92 budget proposals of the Boskin initiative need to be broadened even within the context of "economic" statistics, narrowly defined. Last year, Chairman Boskin testified that statistics tracking income, poverty and the economic status of households had fallen into neglect. However, this year's budget proposals concentrate almost exclusively on business data. Unfortunately, we lack reliable income data for both the top and bottom of the income distribution. The current recession has highlighted the lack of information about workers' transitions over the business cycle and throughout their lives. And the methodology that sets the official

poverty threshold at only \$9,885 dollars per year for a family of three is out of date.

In addition, several witnesses before the Committee have argued that our decentralized system (there are about 70 different statistical agencies) needs more effective coordination. With such a dispersed system, agencies can have redundant efforts or work at cross purposes. The witnesses regretted the decline of the Office of Statistical Policy at OMB, which served this function more effectively in the past. Furthermore, our system needs better coordination with statistical bureaus in other countries. One of the unfortunate consequences of statistical programs' declines in the 1980s was the increasing divergence between U.S. practice and that of other nations.

Our decentralized system also undercuts efforts to maintain an adequate statistics effort. With the various agencies imbedded within much larger departments throughout the government, none of them can muster much support. Outside of the JEC and the current Chairman of the Council of Economic Advisors, both of whom have other areas of responsibility, there is no government advocate for the statistical system as a whole.

Two witnesses from the private sector testified before the Committee this year that the functions of the Office of Statistical Policy should be enhanced and that statistical issues at OMB be segregated from contentious debates over regulation. Martin Fleming, Chair of the Statistics Committee for the National Association of Business Economists, argued for the establishment of a full-time advocate for the statistical system. Charged with the responsibility of periodically reporting on its health, such an advocate might help us avoid the kind of deterioration that occurred year-after-year in the 1980s.

Without renewed investment over several years, weakness in our information base will undermine economic growth, hinder international competitiveness and subvert sensible government policymaking. Though we welcome the Executive Branch's renewed interest in statistics, we believe that its proposals need to be more comprehensive. We need a permanent commitment to better information, a crucial ingredient in better decision-making.

Budgeting for Investment

In all of the areas discussed so far, the persistent theme is that the government is underinvesting in productive assets. Despite little progress in actual investment funding over the past two years, the President's budget submission has reflected increased concern with the issue of public asset

creation. This year's budget, for example, begins its formal presentation of spending plans with a long section emphasizing, "Investing in the Future."

The Joint Economic Committee, which has been emphasizing America's unmet investment needs for several years, welcomes the investment emphasis in the new budget. But we are concerned that the rhetoric of investing is not matched with resources adequate to the task. Investment involves shifting resources from current consumption to asset creation. If the scale of resources being shifted is small, so will be the impact on the creation of assets.

In the FY92 budget, for example, the Administration lays great emphasis on the fact that federal capital outlays will rise from \$114.2 billion in FY91 to \$116.8 billion in FY92. Yet, this rise of 2.2 percent is significantly less than the 4.3 percent inflation rate the budget forecasts for CY91. In real terms, net of inflation, government investment outlays will thus actually fall in the FY92 budget.

Although the Bush Administration claims that its FY92 budget request for education, at \$29.6 billion, is a 9.3 percent increase over FY91, most of the gain is due to accounting changes for the Stafford Loan program. The net increase of \$800 million in new appropriations implies a reduction in real spending after adjusting for expected inflation.

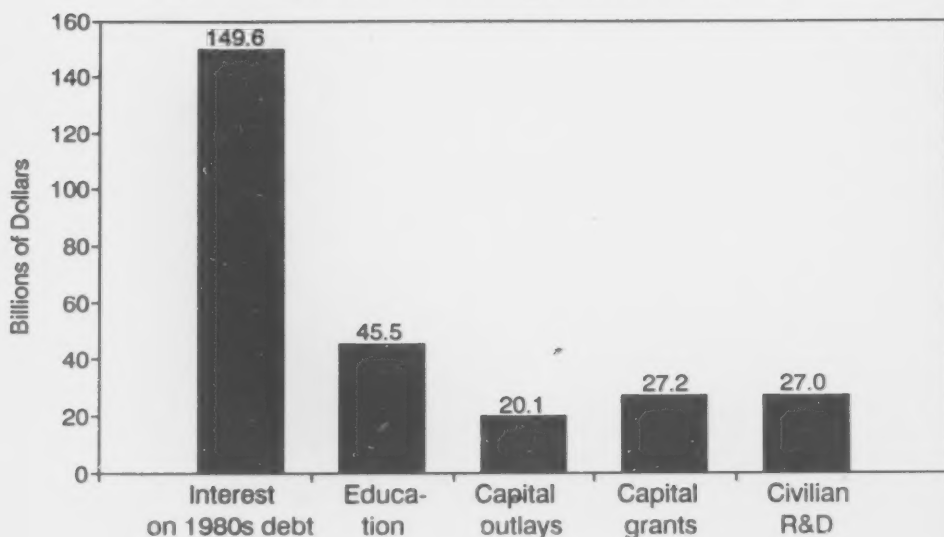
A major reason for inadequate attention to the country's investment needs is the federal budget deficit. We find it difficult to do more asset creation in today's budget, because we are still paying for the liabilities created in the past.

Figure 26 shows the relationship between asset creation and liability servicing in the federal budget. The first bar shows current budget resources devoted to servicing just the portion of federal debt which was accumulated since 1980. The other bars show various "investment" outlays in the current budget. Given the size of today's annual federal deficit, pressures on asset creation are only likely to worsen in the future.

For this reason, it is important that we come to grips with the deficit problem, but it is equally important that reducing the deficit be seen as a means toward the end of increased asset creation in the economy.

In thinking about the federal deficit, it is important that we understand clearly the roots of the problem. Deficits are caused by a mismatch between revenues and spending, not by spending itself. This distinction is obscured by the emphasis in this year's budget on the so-called "problem" of entitlements.

Figure 26
Fiscal 1992 Budget Priorities



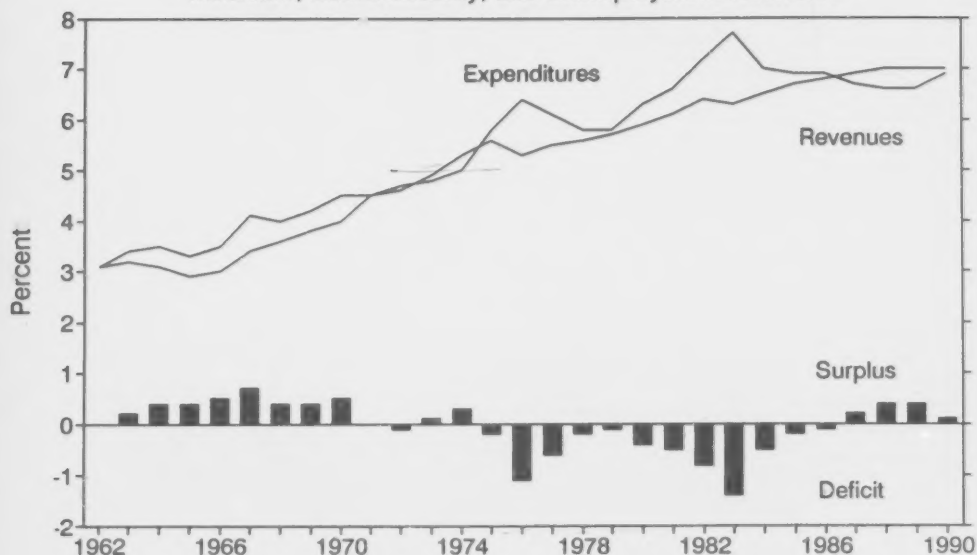
Source: *Budget of the United States Government, Fiscal Year 1992*, historical tables.

The Introduction to the FY92 budget, refers to the budget "being taken over" by entitlement programs, which "have grown from 28 percent of the budget in President Kennedy's Administration to nearly 52 percent today." While entitlement programs have grown faster than GNP during the last 30 years, growth in these programs is not responsible for the federal deficit.

By far the largest entitlement programs are Medicare, Social Security and Unemployment Insurance, which together account for 70 percent of entitlement spending. Yet, these programs are all funded by dedicated taxes, taxes that are more than adequate to meet the needs of the programs. All other entitlements, including Civil Service and Veterans' Retirement, Medicaid, and Food Stamps, have declined from 4.8 percent of GNP in 1975 to 3.2 percent in 1990.

Figure 27 shows the implications for the federal deficit of the funded entitlements. It demonstrates both that growth in outlays for entitlements leveled off during the 1980s, and that, on balance, the funded entitlements actually had an excess of revenue over expenditures. Instead of contributing to the deficit, they act to reduce it.

Figure 27
Funded Entitlements as a Share of GNP
Medicare, Social Security, and Unemployment Insurance



Sources: Congressional Budget Office and Joint Economic Committee.

The federal budget is clearly not "being taken over" by entitlement programs, since growing outlays have been more than matched by dedicated revenues. If the country is to come to grips with the problem of asset creation by the Federal Government, it will need to solve the budget problem in some other way than a simplistic cutting of entitlement programs.

Although neither entitlements nor investment programs are the cause of the federal deficit, the deficit does constitute a major problem constraining the ability of the Federal Government to play its appropriate role in the process of asset creation.

Many economists believe that increased funding for investment programs would be sound fiscal policy even if they increased the deficit. Borrowing to finance assets that help the economy grow faster is a different type of activity from borrowing to finance current consumption. Most state governments recognize this difference, and split their budgets into "current" and "capital" components. Virtually all states are required by their constitutions to balance the current budget, but can borrow to finance prudent investments in their capital accounts.

In the federal budget, however, information on investment outlays under various definitions is presented in budget appendices, where it has recently been given more prominence. However, the distinction between current (public consumption) spending and capital outlays is not routinely integrated into the federal budget presentation in the way that, for example, the distinction between mandatory and discretionary spending, is presented.

We believe that the investment activities of the Federal Government might be better understood and supported if the Federal Government were to establish separate accounts for capital investments. Such a change in the federal budget would be facilitated by adopting the System of National Accounts (SNA), the internationally used accounting scheme. The SNA treat the government sector like the private sector, recognizing that some government purchases of goods and services are used for current consumption, and some represent additions to the Nation's capital stock. Although these accounts only identify investment in physical capital (depreciable), not human capital, they would help to systematize and highlight government investment.

The Committee is inclined to support the efforts of the Administration's Working Group on the Quality of Economic Statistics to move toward the adoption of the SNA as the framework for our national income and product accounts. Movement toward improved accounting for investment in both the federal budget and the national income accounts would serve an important purpose by focusing more attention on the critical question of asset formation in the economy.



CREATING AN INTERNATIONAL CONTEXT FOR GROWTH

Improving the focus of firms, households and government on the creation of assets will clearly have a major positive impact on the long-term health of the American economy. But changes in domestic policy alone are likely to be insufficient by themselves. American producers are steadily becoming integrated into a much larger world economy, and it is an essential task for economic policy to help ensure that the international economic environment remains beneficial to the interests of American producers.

Maintaining a stable and growing world economic system requires the major countries to undertake global "economic diplomacy." The major nations both need to keep the health of the international system in mind when setting domestic economic policies, and maintain a structure of international rules and institutions that maintain global growth.

At present, it appears that global economic diplomacy is falling short on this task with respect to four major dimensions. The macroeconomic policies of the major countries are bringing the world perilously close to a global recession; the international financial system seems unable to transfer investment capital on the scale needed to sustain market-oriented development around the world; the international organizations for trade and finance are failing to resolve the crises that confront them; and the distribution of burdens for maintaining the world system are not being equitably shared.

The United States economy in particular would gain from successful efforts to coordinate macroeconomic policies, especially with the other major "engines" in industrial growth abroad; to remove foreign trade barriers; to achieve exchange rate stability at appropriate levels; and to solve the debt crisis in the developing countries so that they may increase their imports.

GROWTH-ORIENTED MACROECONOMIC POLICY

Throughout the 1980s, the pattern of growth among major industrialized nations shifted the task of encouraging world economic growth among countries and regions. In the early 1980s, the United States played the key role, stimulating world demand considerably, but at the price of piling up an

unsustainable deficit in its trade accounts. Although U.S. trade deficits have remained unacceptably large for the last several years, they have receded and thereby reduced the stimulus from the United States for growth in the rest of the world. Fortunately, Europe and Japan picked up some of the slack; Europe through an investment boom in anticipation of a single market in 1992, and Japan through a more rapid rate of growth in domestic demand as a result of government policy.

As noted earlier, there are growing signs that none of the major countries are now willing or able to play the critical role of "locomotive" for the world system. Figure 13 (on p. 25) shows the recent sharp deceleration in economic growth among all the major economies.

Each major country has its own unique internal causes of slowing, but taken as a whole, the picture of demand growth in the industrialized world is potentially troubling. Germany faces huge costs associated with the integration of the Eastern Lander, costs that were severely underestimated by the German authorities. The decision by Chancellor Kohl to campaign on a platform of "no new taxes" caused renewed fears of inflation in capital markets, forcing the Bundesbank and bond investors to drive German interest rates to levels not seen for years.

Because of the centrality of Germany to the European Monetary System, rising German interest rates exerted strong upward pressure on rates everywhere, contributing to the slowdown in economic activity in the region.

The recent decision by Chancellor Kohl to renounce his no-tax pledge could be a positive development, provided that the Bundesbank reacts quickly to this initiative with sharply lower interest rates. Lower German rates would permit a lowering of rates elsewhere in Europe, allowing domestic demand to revive. Clearly, it should be a major goal of American economic diplomacy to press for lower rates abroad.

A similar case can be made with respect to monetary policy in Japan. Japanese monetary authorities began in the mid-1980s to perceive the boom in asset prices as a speculative "bubble" that both imposed serious costs on the rest of the economy (few could afford to build new homes, factories or offices), and created risks of instability following a sharp correction of market valuations.

To help squeeze out these excesses, the Bank of Japan turned sharply toward monetary restraint during 1990, a move that played a major contributing role to the collapse of global equity markets early in 1990. These moves have also created problems for the Japanese financial system.

With real estate and equity prices falling, Japanese banks see both an erosion in the quality of their assets and a shrinkage of their equity capital base, since regulators allow Japanese banks to include the unrealized appreciation in holdings of corporate stock as part of their core equity capital base. Deflation in asset markets may thus force Japanese banks to make major cutbacks on the rate of growth in new lending. According to Yoh Kurosawa, the newly-appointed president of the Industrial Bank of Japan, these pressures will mean that:

Japanese bankers will have cut asset growth from about 20 per cent a year in the late 1980s to around 5 per cent this year. That's a drastic change. When all Japanese banks slow their expansion rates then margins will go up both inside and outside Japan. Costs for borrowers will rise.¹

These problems in the Japanese financial sector have major international consequences. Japan is a major creditor nation, and much of the world financial system depends upon capital flows from Japan. Current monetary policies threaten not only the Japanese but also the world financial system.

We believe it is time for the Japanese monetary authorities as well as the Bundesbank to put the threat of global recession higher on their list of concerns. Lower interest rates abroad will not only help their economies, it will also increase the latitude for the Federal Reserve to lower interest rates in the United States.

Better coordination of macroeconomic policies among the major trading nations was one of the major goals established in the Omnibus Trade and Competitiveness Act of 1988. The act required the Administration to report twice a year on progress in achieving policy coordination. Although initially opposed to the legislation, the Administration has come to recognize its benefits in practice. We urge the Administration to make the focus of its next report not simply coordination, but coordination in support of a faster rate of world economic growth.

FINANCING REFORM IN THE MIDDLE-INCOME COUNTRIES

The global "credit crunch" may also be wreaking havoc with the economic reform programs now being put in place in a number of middle-income developing countries. Even prior to the stunning collapse of the Soviet bloc, policy-makers in such key middle-income countries as Mexico,

¹ *Financial Times*, November 5, 1990.

Argentina, Thailand and Algeria had come to the conclusion that past policies of import-substitution, external protection and large government enterprise were leading their countries toward an economic dead-end.

In response to these realities, a new commitment to liberalization, market-opening and privatization began to develop within many of these countries. During 1990, they were joined by virtually all of the countries in central Europe that had formerly been integrated into the Soviet Economic Block.

From an historical perspective, this turn toward liberalization and market economics represents an important step forward, yet there is considerable danger that progress on this front will collapse if the reformers cannot attract sufficient external financing to re-start the growth process.

Most of the countries undertaking economic reform have industrial structures that are highly uncompetitive by world standards, a legacy of years of protection and bureaucratic mismanagement. Opening such economies to the global market has the immediate effect of showing the bankruptcy of their firms and slashing the real purchasing power of worker's wages. Liberalization is often accompanied by devaluation, which helps wipe out the value of accumulated financial savings in these economies.

In order to rebuild an economy along market lines, these countries must start creating firms that produce goods or services that meet world standards, a process that requires massive new investment. But investment must be financed, and here the reformers face a vicious circle. Firms and individuals have little accumulated savings that can be translated into new investment because of the ravages of inflation and devaluation. Firms cannot earn enough to finance new investment because their existing capital stock is outmoded, and their products incorporate neither the design nor the technology elements that will make them attractive to world consumers.

The only way out of such a circle is capital investment from abroad, but the reformers' needs for capital unfortunately coincide with a shrinking of the pool of global savings, and a sharp drop in the willingness of major financial institutions to move capital into environments perceived as risky.

On the savings side, the United States is contending with a huge fiscal deficit, while Germany is likely to experience a sharp drop in domestic savings as it copes with the human and social costs of integrating the Eastern Lander. Japanese savings rates may well continue high, but the financial stress resulting from the Bank of Japan's attempt to squeeze out speculative excesses may mean that more of Japan's savings will be retained internally to compensate for past losses in real estate or equity market speculation.

At the same time that private savings flows into world intermediaries may be slowing, the intermediaries themselves are increasingly reluctant to finance new investment in the reforming countries. Banks have been setting aside reserves against probable losses on many of the loans they made to middle-income countries in the 1970s and 1980s, and are also being encouraged by such initiatives as the Brady Plan to reduce voluntarily their claims on debtor countries. In light of these pressures, banks are taking the position that no new cross-border lending should be expected of them to finance economic liberalization.

A new study by the Organization for Economic Cooperation and Development on Eastern Europe provides confirmation of the problem. Borrowing from banks by Poland, Hungary, Czechoslovakia, Bulgaria and Romania dropped from \$2.79 billion in 1989 to \$1.37 billion in 1990, at a time when needs for external capital to finance privatization and reform were immense.

Commenting on the shortage of bank lending, one investment banker noted, "Without funding from the private banks, there's going to be a tragedy of some sort."²

The pattern of inadequate bank lending is not confined to Eastern Europe, however. Banks are refusing to extend additional credit to most developing countries, particularly those with significant past debt burdens. And other forms of private finance, including direct equity investments by corporations, are also falling well short of the need for funds.

In the face of extreme reluctance from banks to lend to reforming countries, multilateral lending institutions have tried to step up their lending. Loans from official creditors have increased sharply as a proportion of total indebtedness in most middle-income countries. However, the expansion of official and multilateral lending cannot be considered as a substitute for private capital flows. Multilateral institutions are too small to carry the burden of financing development by themselves.

Debt reduction efforts have played a mixed role in easing the financing constraint on a number of middle-income countries. A few countries, most notably Mexico, have received significant reduction in their obligations on past debt. Several smaller countries have also managed to reduce debt substantially. But for most debtors, the value of debt reduction has been small. A number of middle-income countries owe the majority of their external debt to official creditors, and progress toward reducing official debt

² Richard Davidson, Morgan Stanley International, quoted in the *Wall Street Journal*, February 27, 1991.

has been slow until very recently. Several larger debtors, most notably Brazil, have so far been unable to conclude significant debt reduction agreements with the commercial banks.

For their part, commercial banks regard debt reduction efforts as an obstacle to extending new loans. Uncertainties surrounding the valuation of existing claims on developing countries have combined with other loan and capital problems in the banking sector to produce a virtual cessation of bank lending to middle-income countries. Bank reluctance has, in turn, made it more difficult for these countries to attract international private investment. Thus, many countries are caught in a tight financial bind--they have not received enough debt relief to grow with their own resources, and they cannot attract enough new external capital to get growth up to the needed level.

In light of these conditions, it is important that the industrialized countries take more effective steps to ease the financing constraint on middle-income countries. The Brady Plan helped push the process of commercial bank debt reduction forward, and the Bush Administration is now pursuing plans to reduce debts owed to official creditors. The recently-concluded agreements on relieving Poland's official debt burden represent an important breakthrough with implications for other countries heavily-indebted to official creditors. But additional steps are likely to be needed. Governments must continue to press for deeper reductions in commercial bank debt in a fashion consistent with maintaining the health of the banking system. Finally, new mechanisms may need to be devised to facilitate the flow of private capital to areas where the current uncertainties regarding economic reform may be inhibiting financing of otherwise attractive investments.

SHARING THE BENEFITS OF EXPANDED TRADE

The third challenge to America's economic diplomats is that of creating a trading system that adequately safeguards the access of American producers to world markets. Growth-oriented macroeconomic policies, and adequate finance for development will do much to maintain the pace of global demand growth, but expanding the access of American producers to foreign markets is not automatically guaranteed by growth.

In the debate over trade policy, economists have reached a general consensus on the following three propositions.

1. Isolation from international trade has bad effects. Firms that are protected from international competition tend to lose technological dynamism and price competitiveness, a particularly serious problem for firms in high-technology industries.

2. There are numerous opportunities for a firm or country to gain from participating in world trade. Trade permits larger and more efficient production (scale economies), scale advantages, and "dynamic" gains from trade.

3. Government policies in trading countries have a significant influence on the distribution of benefits and adjustment costs associated with trade. Tariffs and quotas can limit the expansion of trade, while subsidies and export-promoting activities can shift the balance of competitive advantage in individual markets.

Beyond these relatively simple principles, however, the consensus breaks down. Free market purists insist that all policies affecting trade should be eliminated, since absolutely unfettered competition is guaranteed to achieve the maximum growth in income and living standards among trading nations. Economic theory provides a clear cut case for this position only with some very unrealistic assumptions, such as absolutely free markets, full employment, and universally available technologies that allow countries to make everything for themselves. In such a simplified world, countries trade to gain the advantage of cheaper imports, but there are no offsetting costs from trade expansion. The case for ever freer trade is not clear-cut, however, in a world of active government intervention to influence markets, unused or underused talent and equipment, and rapid advances in private technologies.

Economists have come to recognize that trade creates winners and losers within a country. Trade is expected to increase demand and wages for the workers in a country who have the skills lacking in the trading partner country. Likewise, wages are depressed for those workers with skills more common in the trading partner. Hence, U.S. trade expansion with Mexico would have a different effect on the pattern of U.S. workers' wages than trade expansion with Germany.

Given these uncertainties and complexities, it would not be wise to adopt a simplistic position on trade. Each move to change the Nation's trading rules must be evaluated on its own terms, to determine whether, on balance, the policy change furthers or retards the economic interests of producers and consumers in the country. Such calculations would need to consider not only the short-term consequences of any change, but the longer-term impacts of that change on the trading system as a whole.

At the root of the trade debate is the reality that removal of trade barriers would create severe dislocation in many economies. For reasons that go beyond economic goals to include social and political goals, governments are very reluctant to remove the existing protections that

cushion domestic groups from the full force of international competition. For example, in Europe and Japan, a key problem is agriculture, since both are relatively high-cost producers of such commodities as rice, wheat, corn and beef; yet, each has powerful agricultural constituencies that would be hurt by a regime of free trade.

Among the developing countries, the key issues concern trade in services and intellectual property protection. Many key service industries--particularly in the financial sector--are seen as critical to domestic control of the domestic economy, yet are clearly uncompetitive by international standards. As consumers rather than producers of knowledge and technology, these countries are deeply concerned that intellectual property rules might have the effect of blocking them from sharing in the expansion of knowledge.

These realities suggest the difficulty of negotiating dramatic reforms through broad multilateral agreements, such as those contemplated by the current Uruguay Round of GATT talks. During the early years of the GATT system, American economic interests were coincident with moves toward broad trade liberalization. The United States was by far the largest and most technologically sophisticated economy, and high tariff barriers abroad made it more difficult for American producers to exploit these advantages. American trade negotiators benefited from this coincidence of theory and self-interest, and helped to negotiate several successful rounds of tariff reductions that facilitated the expansion of world trade.

The United States today faces a world of strong competitors with advanced (often superior) technologies and huge potential markets for our exporters. The 12 members of the European Community alone have an economy as large as the U.S. economy and Japan's economy is roughly half that size. (By contrast, the economic output for all of Latin America runs roughly a fifth of the United States.) The convergence of Western Europe and Japan toward the U.S. standard of living and productivity has brought increased trade opportunities for the U.S. economy. As we consume similar products and trade them, we achieve greater scale economies and more consumer choice. More and more, they are developing productive equipment superior to our own that can be used here to raise our own productivity. These conditions argue strongly for a trade policy focused on opening markets for U.S. goods in the industrialized world, particularly Japan and Europe.

High barriers to manufactured imports remain in Japan. The decline in Japan's trade surplus in recent years largely reflects the strength of the yen, not reductions in Japan's import barriers. Talks aimed at reducing

these barriers--the so-called "Structural Impediments Initiative"--have yielded few tangible results to date. According to a recent Business Week editorial:

"...a level playing field has yet to be found in Japan, despite U.S. efforts. It's no longer so much a question of tariffs and formal trade barriers, where the Japanese have grudgingly given ground. What's hurting most now is the way the Japanese have organized themselves into inward-looking groups, or keiretsu. Another impediment to a flat field in Japan is distribution channels. In Europe, they are relatively easy to establish; in Japan, far more difficult. These more subtle barriers are the nub of the bilateral Tokyo-Washington Structural Impediments Initiative. So far, progress has been conspicuously absent. The fact, however, that the Americans have been able to crack Western Europe thanks to a relatively even playing field means that it is time to redouble the pressure on Japan through SII talks and other trade and industrial fronts."

In Europe, the problem facing U.S.-based producers is government determination to intervene on behalf of "national champions." Air France has just received \$394 million in capital from the government, and the United States has filed a trade complaint against German Government subsidies to Daimler Benz in association with the Airbus project.

The U.S. negotiating agenda should also recognize that the "EC 92" project to unify the European market shows that governments are more willing to harmonize their regulations and put boundaries on their subsidies than to commit to the elimination of both. Such a recognition would allow the United States to negotiate effectively on regulations that do not discriminate against U.S. producers, and on subsidies having less damaging consequences for U.S. companies.

SHARING THE BURDENS OF LEADERSHIP

Finally, America's economic diplomats must also negotiate new relationships among the major powers concerning the burdens of maintaining a stable and expanding international system.

The war in the Persian Gulf may introduce a new era of collective security. At the outset of the crisis, there was a global condemnation of Iraq's invasion of Kuwait, and a successful effort, led by the United States, to achieve multilateral support for economic and military sanctions against the aggressor. Unfortunately, the contributions from the allied coalition are uneven and often unsatisfactory.

The responses of the European Community, except for a few countries, have been especially disappointing. Britain and France alone supplied significant ground combat personnel to the Gulf effort, and the pledges of financial support from other countries have far exceeded actual payments received from them.

The longer term challenges raised by the crisis in the Middle East will come after the war. Because the destruction of the war took place in an oil-rich region, it is likely that much of the cost of reconstruction can be financed by the countries themselves. Although reconstruction is thus unlikely to create additional burdens for the allies, it will also involve questions about the appropriate distribution of benefits and responsibilities.

This reality points to the central problem facing the leaders of the world as they try to define the shape of the post cold-war era. The United States remains the undisputed centerpiece of the global security system, but our willingness to bear the burden of military security encourages others to become "free riders"--enjoying the benefits of security without sharing in the costs.

Over time, it is clear that if the United States spends 5 to 6 percent of GNP on the military, while other industrialized countries spend less than half as much, these other countries will have more resources available for building competitive industries and technologies in the civilian sector. Such a pattern cannot help but harm the economic interests of the United States, and it is imperative that we find better means for sharing the burdens of world leadership.

The Defense Burden

The issue of burdensharing for common defense has been contentious for many years. It was intended, under the North Atlantic Treaty, that the burden of defending the West against the threat from the Soviet Union would be "shared equitably among the member countries." NATO began on a more or less equitable basis, in light of relative economic capacities, but the experience eventually became lopsided from an American perspective.

For collective security to work, the principle must be that nations with shared interests share the burden of collective action in an equitable way. It may not be generally remembered that in 1949, when NATO was established, the United States and the larger nations of the alliance carried defense burdens that were roughly equivalent. But a burdensharing gap appeared by 1955 that has persisted for more than three decades.

Historically, the European allies have allocated about half as much as the United States in shares of gross domestic product spent for defense. Japan's defense burden has never risen significantly above 1 percent of its GDP, a small fraction of the U.S. burden. In the period 1980-88, the NATO allies devoted an average of 3.5 percent for defense compared with 6.2 percent for the United States.

The disparity within NATO is underlined by the relative size of the various economies. In 1988, the U.S. share of the combined GDPs of all NATO countries was under 47 percent, but the U.S. share of the combined defense burden was 64 percent. On a per capita basis, Americans pay far more for defense than our NATO allies or Japan, despite the fact that several of them have higher per capita GDPs.

The reasons for the disparity are complex. Some question the validity of the financial comparisons by arguing that other factors should be taken into account. Other factors do matter. It is important that the European countries host U.S. forces on their territories and that some of them have joined the United States in various peacekeeping efforts. The economic costs of conscription understate the defense expenditures of those governments that employ a military draft. When military capabilities are considered, the allies' contributions are substantial.

The nonfinancial factors do not change the overall picture. Even the Defense Department, which usually tries to avoid criticism of the allies, finds fault with the level of allied contributions. It states in its *1990 Report On Allied Contributions To The Common Defense*,

Some appear to be doing at least their fair share or substantially more, others appear to be doing substantially less than their fair share, while a third group of nations shows performance that can best be characterized as mixed.

The distinguishing feature of the nations that are doing less than their fair share, the Pentagon finds, is that they have relatively prosperous economies and relatively high standards of living, yet they devote relatively small portions of their resources to defense.

The Development Burden

As the Defense Department's burdensharing report points out, economic aid to developing countries is sometimes cited as part of a nation's overall defense burden. This form of spending does not add directly to NATO's military capabilities, or those of the West generally, but it does contribute to regional stability. In the final analysis, economic aid to

developing nations may contribute at least as much to real national security as direct military spending. Of course, aid expenditures constitute a burden on the donor's economy.

For these reasons, our allies believe that the amounts they give in foreign economic assistance should be counted as part of their defense burden. This approach is also consistent with Japan's concept of "comprehensive security." Under the Japanese concept, economic and technical assistance to developing nations is an integral part of national security policy.

The allies argue that because most of them spend relatively more on foreign economic aid than the United States, when aid is measured as shares of GDP, the burdensharing gap is narrower than it appears. The argument is correct in direction, but very small in magnitude, since the absolute amounts spent on foreign aid are very small in comparison with the amounts spent on defense.

The OECD defines official development assistance (ODA) as those resources provided to developing countries and multilateral institutions. To qualify, the resources must promote the economic development and welfare of developing countries as the main objective, be concessional in character, and contain a grant element of at least 25 percent. They consist of grants as well as development and other types of loans.

In 1988, the United States spent 0.2 percent of its GDP on official developmental assistance. Japan and the United Kingdom spent 0.3 percent, Germany spent 0.4 percent and France spent 0.7 percent. But the amounts spent are dwarfed by military expenditures. Most countries spent a few billion dollars, at most, on ODA. France spent \$6.9 billion and Japan spent \$9.1 billion. (U.S. outlays were \$10 billion in 1988.) In contrast, the United States spent \$293 billion on defense that year. Total defense spending by NATO and Japan was \$489 billion; total ODA was \$44 billion.

The need for greater development assistance from the West is readily apparent, as is the capacity of the West to provide more assistance. Yet, in the decade of the 1980s, official development assistance failed to grow. In fact, it declined slightly in constant dollars.

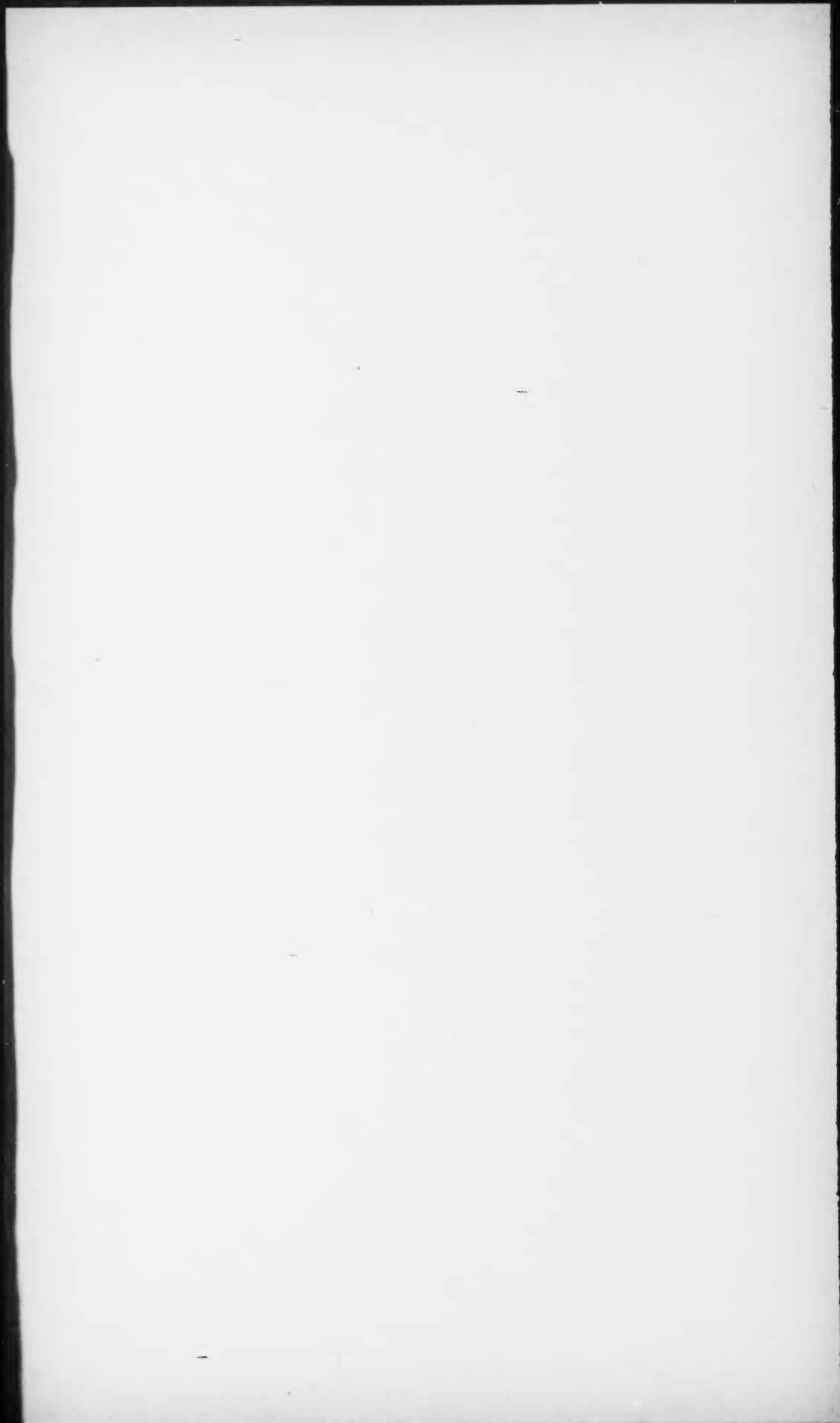
The disparity in burdensharing can be redressed in several ways. One way would be to address the military side of the equation. The allies could increase their defense spending relative to the United States, or the United States could reduce its defense spending relative to the allies. With the diminished military threat from the Soviet Union, and the demise of the Warsaw Pact, it is likely that both the United States and the NATO allies will reduce their defense budgets. A more equitable sharing of the defense

burden would require the allies to reduce their military spending at a slower rate than we cut ours, but recent history suggests that this will be difficult to achieve.

Another possibility would be to address the developmental side of the equation. In a framework of comprehensive security, efforts to assist the economies of the underdeveloped nations should be counted as contributions to the common defense. Such contributions can be increased through official development assistance, or foreign economic aid. But there are other ways that would work just as well. Generous debt-relief schemes for the heavily indebted developing nations and giving them greater access to western markets are two examples.



MINORITY VIEWS



Chapter I

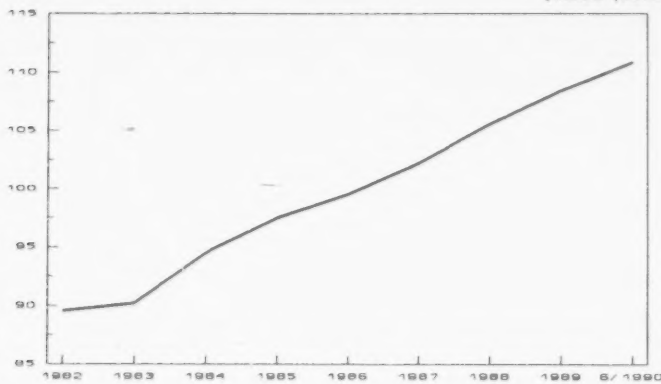
RESTORING ECONOMIC GROWTH

Economic Review and Outlook

The longest peacetime economic expansion in U.S. history ended last summer due to a variety of factors including Iraq's invasion of Kuwait, which forced oil prices sharply higher. The recession will probably be moderate in both length and severity. It should be evaluated in the context of the economic progress made since President Carter left office amidst economic disarray in 1981. Fortunately, the momentum of the expansion from the 1980s has made the economy very resilient in the face of the recent oil shock and war in the Persian Gulf.

The foundation of this expansion was laid in the new policy direction adopted in 1981 and implemented in 1982. An across-the-board income tax cut reduced income tax rates for all, while monetary restraint and stability crushed inflation and thereby reduced interest rates. With the adoption of these new policies, an economic rebound began in late 1982 and continued through 1990. Between 1982 and the third quarter of 1990, real GNP grew by 31 percent. Economic growth replaced the stagflation, malaise and plunging real incomes characteristic of the late 1970s.

Graph I.1 -- Expansion Creates 21 Million New Jobs, 1982-90
(Jobs (millions))

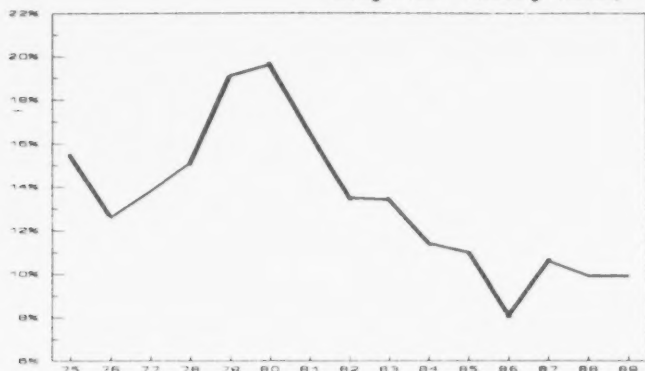


Source: Bureau of Labor Statistics

As Graph I.1 indicates, this economic expansion created 21 million new jobs, generating new occupational and business opportunities. It also boosted median family income 12 percent. The number of new U.S. jobs created during the expansion exceeded that of all the other advanced industrial nations combined.

Another indication of economic progress in the 1980s is the reduction in the misery index during the decade. In 1980, the misery index, the sum of the inflation and unemployment rates, stood at 20 percent. As can be seen in Graph I.2, since 1980 the misery index has trended downward and is now at its lowest level since early 1970s.

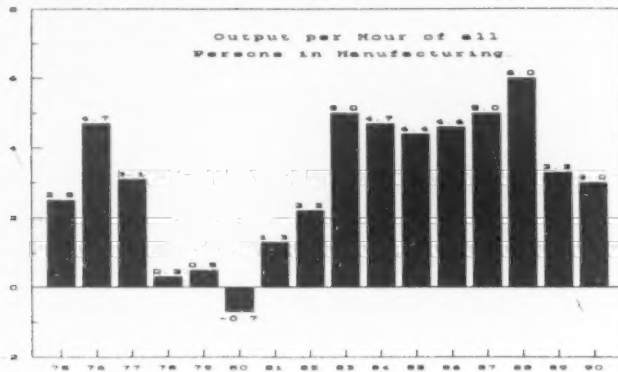
Graph I.2 -- Misery Index,* 1975-89



*Sum of CPI rates and unemployment rates.

The economic progress in the 1980s is also reflected in the average income of the bottom fifth of families. In 1980 the average income of this group dropped \$515, the largest annual decline on record. The economic deterioration already in motion in 1980 spilled over into 1981 and 1982, leading to further income losses. But during the last expansion, the average real income of these families jumped by 12 percent. Partisan criticism notwithstanding, the data show that policies of economic growth benefitted low income families, while those of the malaise era harmed their economic welfare.

The 1980s were a time of innovation and restructuring for U.S. industry. As a result, American industry achieved strong manufacturing productivity gains and improved international competitiveness. Graph I.3 below illustrates the rebound in manufacturing productivity in the 1980s.

Graph 1.3 --Productivity Gains in Manufacturing, 1975-90

Source: Bureau of Labor Statistics

Real economic growth should be the objective of economic policy because it is the best way to provide jobs, income gains, and a higher standard of living for all people. As John F. Kennedy said, "A rising tide lifts all boats." Recession undermines the economic welfare of all and tends to harm especially the most vulnerable Americans.

Restructuring of American Industry

In the mid-1980s ideological criticism of the Reagan-Bush expansion relied on the belief that it was all an illusion. A cluster of arguments was developed to support this view. For example, allegations were made that the economy was "deindustrializing" and that the admittedly brisk job creation wasn't really that impressive because it was almost all in low paying, dead-end service jobs. Supposedly, wealth was becoming increasingly and sharply concentrated in the hands of the rich. It was also asserted that income of the poor fell in the Reagan years. Some said that only the coastal regions of the United States benefitted from the expansion. Others said, American industry was a pathetic punching bag for omnipotent foreign firms. This drumbeat of criticism continued even after the individual arguments were exposed as factually wrong.

Most recently, the Department of Commerce released the results of a 2-1/2 year report on trends in industry during the 1980s. Its results are not surprising, but they are important. During the 1980s American industry restructured to increase efficiency and productivity. The 1982-88 annual manufacturing output growth of 6.5 percent outpaced the overall GNP growth rate of 4.1 percent during the same period. The manufacturing share of GNP

increased from 21.1 percent level in 1980 to 23.0 percent in 1988, about the same as three decades ago. Manufacturing productivity during the expansion averaged 4.5 percent. The notion of "deindustrialization" was just another myth touted by those anxious to undermine the economic progress of the 1980s.

Economic Outlook

According to a panel of the National Bureau of Economic Research, the current recession began last summer. Payroll employment has been declining for several months now, and industrial production has been sliding since September. Real GNP declined 2.0 percent in the fourth quarter of 1990. The diffusion indexes have reflected broad weakness across most industries. The construction and auto industries have been among the hardest hit in the goods producing sector, with little prospect for immediate improvement.

Both the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) project that GNP declined in the fourth quarter of 1990 and the first quarter of 1991. On the brighter side, they both agree that the economy will rebound by mid-year 1991 and into 1992. The case for a rebound soon is buttressed by the absence of high inflation and interest rates at the end of the upswing and by the lack of excessive inventory accumulation. Oil prices retreated sharply from their recent highs despite the onset of war. Furthermore, our quick military victory will almost certainly stabilize oil prices at even lower levels.

However, there are looming problems that could affect the timing of the recovery. The credit crunch, whether due more to excessive regulation or an unwillingness to lend in recession, or some combination of the two, is a restraint on the economy. In addition, weakness in parts of the financial sector could also undermine the resumption of economic growth.

Policies for Economic Growth

The existence of recession raises the issue of an appropriate policy response. Record levels of federal deficit spending make pump priming through even higher deficits irresponsible. Prospects for timely congressional action to alleviate the recession are not promising. Probably the most constructive course for congressional action would be to avoid serious mistakes such as counterproductive tax increases. Taxes as a percent of GNP are already at historically high levels.

One general problem of income taxation is its inherent bias against saving. Under an income tax, the amount saved is taxed and the return to such saving is taxed yet again. Yet the same amount, if consumed, is taxed only once since there is no return. Thus the income tax raises the price of saving relative to consumption.

Saving is a key to higher productivity, economic growth and enhanced living standards. Adequate private savings are necessary to fund investment in plant and equipment to enhance worker productivity. Productivity growth, in turn, increases real income for workers and families. As such, adequate savings is the prerequisite in a chain of events leading to renewed prosperity. The U.S. tax laws need to be revised with these critical relationships in mind.

Current U.S. tax law is a hybrid containing elements of both income taxation and consumption taxation. For instance, the U.S. "income" tax code contains many provisions, such as restricted IRA rules, which are designed to soften the tax bias against savings. The specific bias against saving and investment takes many forms, including double taxation of personal saving, and multiple taxation of capital gains as well as corporate income. Liberalization of IRAs and less punitive treatment of capital gains would be steps toward paring the tax penalty on saving and investment.

Congressional action to lower government taxation of labor and capital would lower the tax penalty on work and investment, boosting the economy. A rollback of previously enacted increases in taxes on workers, investors, and savers would help end the recession and provide a stronger basis for resumption of economic growth. The Republicans of the Joint Economic Committee support the capping and rollback of excessive taxation.

The federal government can promote economic growth by ensuring that federal tax policies promote additional savings to provide capital available for productive investment. Tax policy which discourages savings and investment shrinks the amount of investment funds available, and raises interest rates for the funds which are available. Increased domestic savings would reduce our dependence on foreign capital to finance government debt and industrial innovation.

We believe that we cannot tax and spend our way to prosperity. Any calls for federal spending increases should be firmly resisted.

Chapter II

**THE TURNAROUND IN FAMILY INCOME:
A REVIEW OF THE 1980s¹**

This chapter reviews trends in the incomes of low, middle, and upper income Americans. Factual information about family income is important because it can influence federal policy over a wide range of economic issues. As one would expect, family income has trended upward during the current economic expansion, recovering from the declines which began after 1979.

The growth in family income during the 1980s was positive for all quintiles (fifths) of families, though not quite as rapid as that during the fastest paced years in the postwar period. The setback to income growth during the 1970s and 1980 was erased, as real median family income climbed substantially above the levels of the early 1970s.

The economic situation in the late 1970s and 1980 provides the context for evaluation of income trends during the 1980s. A salient point about recent income trends is that 1980 stands out as the worst single year in the postwar period for family income. The middle American family lost about \$1,800 in 1980 alone, the biggest drop in the official real median family income measure (as measured by the CPI-U index) since World War II.² If each of the last seven years of data had repeated this performance, the middle American family would have lost \$12,600 in real income since 1982.

Any reasonably objective appraisal of the economic and income trends as the United States entered the 1980s would be negative. The stagflation of this period set off several consecutive years of income decline; indeed, many economists consider the period between 1979 and 1982 to be one economic contraction. Conversely, it is just as clear that the situation near the end of the decade showed marked improvement. During the expansion, the income of the bottom fifth of families climbed 11.9 percent, while that of the middle fifth of Americans families gained 12.6 percent. Because of the starkly

¹ An earlier version of this chapter was released by Senator Connie Mack as a Republican JEC staff study in October 1990.

² Economic Report of the President, Washington, D.C., 1990, p.328.

different situations at the beginning of the decade and later, it is important that the two eras not be confused.

Unfortunately, reports and analyses of family income data too often rely on arbitrarily defined periods. For example, statements have been made that the income or earnings of some income or family group fell x percent between 1978 or 1979, and some end point in the 1980s. On the other hand, one can just as easily observe that in the period between 1977 and 1980, real median family income declined by \$1,121. To avoid problems inherent in any selective choice of years, annual data are presented in tables and charts so that the reader can draw his or her own conclusions.

The unusually negative year of 1980 makes presentation of annual data essential. The sharp 1980 decline in income was felt by all sectors of the population, but was especially pronounced for the poorest fifth of families and households. Any period or grouping of data that includes the 1980 decline with other years will be negatively affected by this fact. Therefore, analysis which does not present annual data or jumps from, for instance, 1979 to 1987, or 1988, should be approached with extreme caution. The lumping of 1980 income changes with later years presents a distorted picture which lends itself to misinterpretation. The record 1980 drop in income relative to 1979 should not be attributed to any other year or years.

Some contend that government policy made the rich, richer, and the poor, poorer, during the last decade. The numbers make it clear that this contention is wrong. Use of appropriate base years and inflation adjustment entirely refutes the contention that income declined in the 1980s. The distinction between high income and wealth is also important. A family with relatively modest income may have highly valued investments and other assets, and thus be wealthy. Alternatively, a family with relatively high incomes may have few assets, and thus not be considered wealthy. In general, however, the focus has been and remains on annual income measures.

In a market economy most income is privately generated by mutual agreement between two or more persons, such as an employee and an employer. There is no "Distributor" of income as such, so attacks on government policy are misplaced.³ Moreover, the related argument that the middle class is shrinking due to downward mobility is false.

It is more useful to examine whether the incomes of low, middle and affluent families reflect progress. It would be small consolation for a poor person to learn that one's share of total income has increased slightly, but at

³ Hayek, F.A., *Studies in Philosophy, Politics, and Economics*, Chicago, 1967, pp.170-171.

the price of a significantly lower level of income. What is relevant is that as many as possible over time get a larger piece of a growing economic pie.⁴ The most important question regards the direction of the level of income for most families -- is it going up or down?

The Fall and Rise of the Middle Class

According to a variety of employment and income data, there is indeed evidence that the middle class as a share of all families is in decline. The reason is not that a growing proportion of Americans is unemployed or homeless, as some have argued, but that it has moved upward to a higher income level during the 1980s. In other words, a significant portion of the middle class has moved to a higher, not lower, level of income.

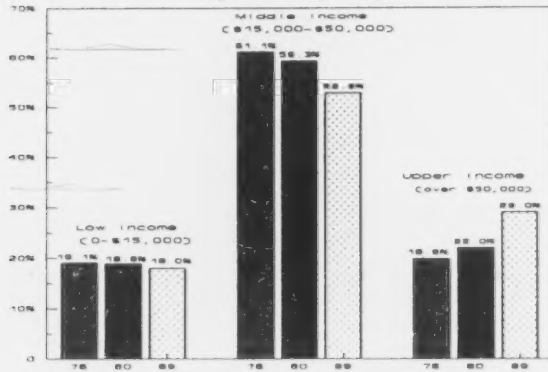
The Bureau of the Census is generally considered the authoritative source of income and poverty data. Census Bureau data are used below.⁵ Families are classified by income as "lower" with income under \$15,000, "middle" with income between \$15,000 and \$50,000, and "upper" with income above \$50,000. Thus, families are organized by the level of their income in the years 1973-89. According to these Census Bureau data, the unfavorable trend starting in the late 1970s was reversed during the current expansion. A review of the situation at the beginning of the decade makes this clear.

The share of families under the low income threshold of \$15,000 climbed from 17.6 percent in 1979 to 18.8 percent in 1980, an increase of 1.2 percentage points. The share of high income families slipped from 23.2 percent to 22.0 percent. Meanwhile, the proportion of middle income families also dropped, reflecting downward mobility. In other words, economic conditions for middle income families deteriorated, boosting the share falling below the lower income threshold. This deterioration in 1980 cuts across all income groups, but was especially severe for the lower income group.

⁴ Browning, Edgar, "Inequality and Poverty," *Southern Economic Journal*, April 1989, pp.819-829.

⁵ Census Bureau data reported in Current Population Reports, Series P-60, *Money Income and Poverty Status in the United States*, published annually. This is the source for most data used in this section.

**Graph II.1 -- More of the Middle Class Has Become Affluent
(percentage of families by income group)**



Source: Bureau of the Census.

On the other hand, data from Table II.1 and Graph II.1 show that since 1980 the share of families classified as low income has declined, while that classified as high income has increased sharply from 22.0 percent to 29.0 percent. The middle class declined from 59.3 percent in 1980 to 52.9 percent in 1989 because more of them moved above the \$50,000 threshold defining the entrance to the upper income group. Between 1980 and 1989 the share of high income families jumped 32 percent, virtually all from the middle class.

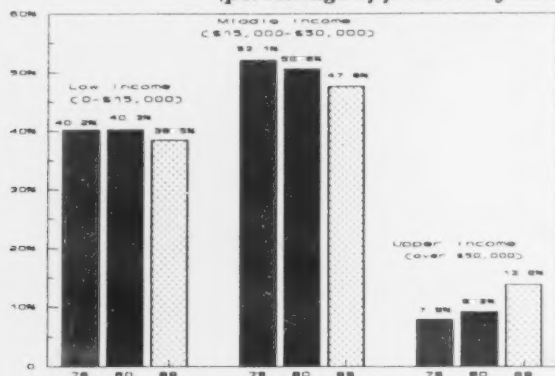
Table II.1
Percent of Families by Income Group
(1989 dollars)

Year	Low Income (Under \$15,000)	Middle Income (\$15,000-\$50,000)	High Income (Over \$50,000)
1973	18.2%	61.2%	20.5%
1976	19.1	61.1	19.9
1977	19.1	60.0	21.1
1978	18.4	59.1	22.6
1979	17.6	59.1	23.2
1980	18.8	59.3	22.0
1981	19.9	58.6	21.6
1982	20.7	57.6	21.5
1983	21.0	56.7	22.3
1984	20.2	55.8	24.0
1985	19.7	55.5	24.7
1986	18.9	54.5	26.6
1987	18.3	54.2	27.5
1988	18.4	53.5	27.9
1989	18.0	52.9	29.0

Source: Bureau of the Census.

As Table II.1 shows, the recent trend is favorable, with a smaller share of families since 1980 classified as lower income, and a greater share as upper income. This marks a reversal of the stagflation period, when the combined share of middle and upper income families declined, while that of the lower income expanded.

**Graph II.2 -- Black Families Also Move Up (1989 dollars)
(percentage of families by income group)**



Source: Bureau of the Census.

A similar but sharper pattern is seen in black family income. One of the least known developments in the 1980s was the increase in the proportion of black families earning over \$50,000 annually. Though not all blacks were this fortunate, Graph II.2 also reflects economic progress of low and middle income black families.

The Level of Family and Household Income

There are a number of ways of measuring income trends and defining low, middle and high income. Real median family income measures the middle family in the income distribution, 50 percent from the bottom and 50 percent from the top, in each year. Another classification method commonly employed divides families or households into fifths, and presents the average income for each fifth.

Each year the Bureau of the Census reports⁶ the level of median (the 50th percentile), or middle, family income for the previous year. Generally, income trends are positive during periods of healthy economic growth and negative during periods of economic trouble. Table II.2 below shows that real median family income started to trend downward after 1979. The stagflation

⁶ Current Population Reports, Series P-60, Money Income and Poverty Status in the United States: 1989 (and earlier years), U.S. Census Bureau.

of this time reflected the fact that inflation outpaced income growth, leading to declines in real (inflation adjusted) family income. The inflation adjustment used below is based on the CPI-U-X1, generally acknowledged as superior to the CPI-U as an inflation measure, because it more accurately accounts for typical family housing cost.

Based on the inferior inflation measure, much has been made of the notion that the recent level of real median family income seemed virtually unchanged relative to 1973. Often this is presented as though it was a problem of current policy. However, when the CPI-U-X1 index is used to remove the distortion in the standard CPI-U, the 1973-89 gain in real median family jumps by \$2,554. In other words, this argument that real median income reflects no real progress since the early 1970s is based on a statistical illusion created by use of the flawed CPI-U index.

Table II.2
Family Income Trends
(constant 1989 dollars)

Year	Middle American Family Income*	Change From Previous Year
1973	\$31,659	\$614
1976	31,225	955
1977	31,410	185
1978	32,405	995
1979	32,821	416
1980	31,675	-1,146
1981	30,811	-864
1982	30,394	-417
1983	30,719	325
1984	31,547	828
1985	31,962	415
1986	33,328	1,366
1987	33,805	477
1988	33,742	-63
1989	34,213	471

Source: Bureau of the Census.

* CPI-U-X1 used for inflation adjustment.

By raising family income as a political issue, critics invite a closer review of the record on family income. The data show that once the economy was permitted to escape from the stagflation which began in the late 1970s, family income began to grow again. Of the \$2,427 decline in family income between 1979 and 1982, about half took place in 1980, while the remainder

is clearly a hangover from previous policy in place during the late 1970s. After a new policy direction was set in 1981 to encourage economic growth, family income expanded with the economy, as reflected in the table above. During this longest peacetime expansion (1982-89) in U.S. history, middle (median) American real family income rose by 13 percent, to a record high, even after adjustment for inflation.

The trend in household income is similar to that of real family income. One of the weaknesses of family income measures is that the income of those who leave family units is not counted -- household measures include all members of households whether in families or not. Thus, the coverage of the household income measure is broader and more inclusive than that of family income.

Table II.3
Household Income
(1989 dollars)

Year	Middle American Household Income*	Change From Previous Year
1973	\$27,616	\$534
1976	26,483	447
1977	26,629	146
1978	27,673	1,044
1979	27,583	-90
1980	26,683	-900
1981	26,251	-432
1982	26,163	-88
1983	26,167	4
1984	26,751	584
1985	27,218	467
1986	28,168	950
1987	28,447	279
1988	28,537	90
1989	28,906	369

Source: Bureau of the Census.

* CPI-U-X1 used for inflation adjustment.

The turnaround in household income can be seen in the rebound from the 1979-82 decline. The performance of the economy and the direction of real income is closely related. The sharp declines at the end of the last decade and the beginning of the 1980s were reversed.

Alternative Family Income Measures

Division of families into fifths permits examination of how the various income quintiles, or fifths, fared over time. As Table II.4 below shows, income at all levels fell sharply during the stagflation year of 1980.

Table II.4
Real Average Family Income
(in constant 1989 dollars)

Year	Lowest Fifth	Second Fifth	Middle Fifth	Fourth Fifth	Highest Fifth
1973	9,783	21,351	31,370	42,872	\$73,557
1974	9,636	21,035	30,783	42,172	72,121
1975	9,291	20,235	30,153	41,288	70,541
1976	9,509	20,740	31,017	42,379	72,440
1977	9,361	20,817	31,394	43,325	74,276
1978	9,650	21,475	32,319	44,530	76,566
1979	9,801	21,623	32,657	44,970	77,922
1980	9,286	20,852	31,588	43,828	75,049
1981	8,906	20,144	30,916	43,411	74,419
1982	8,427	19,834	30,381	43,093	75,903
1983	8,409	19,869	30,634	43,668	76,823
1984	8,692	20,406	31,554	45,123	79,518
1985	8,808	20,677	31,985	45,845	82,510
1986	9,095	21,396	33,204	47,447	86,423
1987	9,248	21,734	33,749	48,301	88,271
1988	9,284	21,712	33,787	48,524	89,033
1989	9,431	22,018	34,206	49,213	92,663
Percent Change					
1973-80	-5.1%	-2.3%	0.7%	2.2%	2.0%
1979-80	-5.3	-3.6	-3.3	-2.5	-3.7
1981-89	5.9	9.3	10.6	13.4	24.5
1982-89	11.9	11.0	12.6	14.2	22.1

Source: Bureau of the Census and author's calculation.

Average Family Income By Quintile

Average family income by quintile has recently been published by the Bureau of the Census. The averages shown are inflation adjusted (1989 dollars) using the CPI-U-X1 index. Here "family" has the conventional

meaning; single individuals are not included in the family definition, as in one recent report based on CBO simulations.

Average incomes have risen for all groups since 1981. The gains for the lowest quintile amounts to 5.9 percent, while that of the middle quintile is 10.6 percent. The income gains of the highest two quintiles reflect higher growth. Of course, the income gains during the expansion period (1982-89) are even sharper. For example, during the expansion, the average income of the bottom fifth of families rose by 11.9 percent.

Although some seem to target the income gains of the "richest" fifth for criticism, these attacks are made without disclosing the fact that families need only about \$59,550⁷ of income to enter this category. Many two-earner couples in this category undoubtedly do not consider themselves rich, and would not consider their income as legitimate targets of redistributionist social policy.

Income and Public Policy

It is important that factual information about income trends be accurate. Apart from the question of what is actually happening is the separate question of policy. What is the appropriate role of government with regard to income distribution? That government can and should provide a subsistence level of income to assist the poor is widely accepted.

Beyond this is the question of whether further distribution of income should be a goal of government policy. This is a value judgment, and cannot be resolved by economics. Nonetheless, though income equality may be advocated with the best of intentions, there are very good reasons to question the ability of government policy to redistribute income without violating individual freedom and eroding living standards. As Nobel Laureate F.A. Hayek⁸ has pointed out, income redistribution as an objective of policy cannot be effected without eroding or destroying the foundation of a free society. The problem is that a single, unitary set of values is used to weigh the contributions of each member of society, which means that only one set of many value systems imposed on society by the force of government.

By providing a legal and policy framework that permits operation of market forces, government can facilitate income growth. However, when income redistribution becomes a goal of policy, it tends to distort decision-making, and living standards decline. The recent political history of Europe,

⁷ This defines the bottom income threshold of the top fifth of families.

⁸ Hayek, p.173-174.

as well as that of our own country, provides plenty of examples. One may value income equality so highly that its negative economic costs are outweighed whatever the consequences. In addition, one may further attack inequalities of wealth by requiring redistribution of personal assets and property. Fortunately, most people in the world seem to prefer the reality of higher living standards to the hypothetical illusion of equality of income or wealth.

The growth policy of the early 1980s sought to lower tax barriers to employment of labor and capital in production. The objective was to make the economic pie bigger so everyone could have a larger slice. This is more important than the relative shares one or another group receives of a shrinking economic pie. In 1980, the economic pie was shrinking, and everyone was worse off as a result.

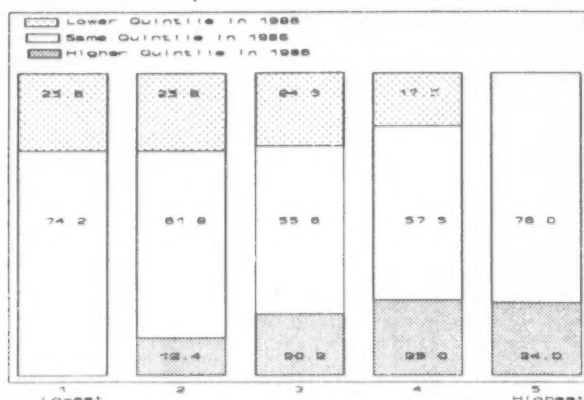
The key question is whether these low-income families are better off in the economic environment of 1980 or 1989. In 1980, the share of income received by the bottom 20 percent of families was virtually unchanged from the previous year, but their incomes and standard of living were much lower. The poor actually were poorer, as was everyone else. During the economic expansion the measured share of income going to the bottom 20 percent seems to have declined slightly, but Table II.4 demonstrates that by 1989 the level of income and the standard of living has risen for Americans at all levels of income relative to 1980.

Measuring Income

The measurement and definition of income are fraught with difficulties. Most official income data are based on cash income, and exclude noncash transfers. As a result, much income is simply not measured at all.

Measures of income dispersion typically rely on what share of total family income was earned by each consecutive quintile, or 20 percent grouping, of all families or households. The Bureau of the Census, for example, divides all families by income levels into classes of lowest fifth, second fifth, middle fifth, fourth fifth, and top fifth for each year since 1947, and allocates the income of each quintile accordingly.

Graph II.3 -- Percent of Persons by Change in Income, 25-44 Years Old Quintile: 1985-86 (Percent of Persons)



Source: Bureau of Census.

Some observers use this information as though the quintiles are composed of roughly the same families, ignoring factors such as upward and downward mobility, divorce, demographics, family size, labor force participation, and social changes. In particular, the fluid movement of particular families in and out of the various quintiles is not reflected in these data. For example, nearly one fifth of those in the bottom quintile during 1985 had moved to a higher quintile in the next year, while almost one quarter of those in the highest quintile had dropped to a lower quintile. Two reports⁹ in the mid-1980s found this degree of income mobility typical each year; the effect over several years would clearly be even greater. Mobility among young families is evident in Graph II.3.

Of course, young families tend to start in the lower quintiles and work their way up as they acquire more work experience and productivity. Eventually after retirement, annual income tends to fall. This pattern of income over the life cycle is well established. The point is that annual income data reflect only a snapshot of family income, whereas a lifetime measure of income would be a better measure of economic well-being and supply a more valid basis for income comparisons.

⁹ Current Population Reports, Series P-70. Transitions in Income and Poverty Status: 1985-86 (also 1984-1985).

Furthermore, income may not be the best measure of economic well being. After all, the purpose of generating income is ultimately to maintain consumption over the long term. Per capita consumption by quintile is much more equally dispersed than is income. Also, those in the lowest quintile actually consume more than the level of their cash income.

The policy of economic growth has succeeded in increasing family incomes across the board. Despite their relative position in the income distribution, families at all levels have seen real income gains of at least 10 percent since 1982. This reversed the declines in real income which began in the late 1970s. The real income of the lowest fifth of families has grown 12.6 percent during the expansion, so assertions of income decline for this group are not accurate.

The statistical record confirms the well-established fact that income trends are linked to the economy. The level of family or household income increases during economic expansions and declines during economic contractions. The key to continued income growth is a continuation of the economic expansion. If policies are adopted which cut the expansion short, one result will almost certainly be a fall in real income and American living standards.

Chapter III

THE FEDERAL INCOME TAX BURDEN
(1981-88)¹⁰

The impact of the federal income tax burden has been hotly debated in recent years in discussion over the budget as well as the Economic Recovery Tax Act (ERTA) of 1981. This latter measure, popularly referred to as Kemp-Roth, or the Reagan tax cuts, reduced personal income tax rates 23 percent across the board. As its name suggests, ERTA was designed to reduce the tax barriers to labor and capital flowing to production, thereby boosting output. Apart from the question of this measure's economic impact, a separate issue was raised about its effects on personal tax payments by various income groups. Much of this discussion has relied on partisan politics and appeals to base emotion rather than a consideration of the factual evidence.

Such sentiments are very old, of course. In the 18th Century, egalitarian political theorist Jean-Jacques Rousseau, in *Emile*, wrote, "What was hardest to destroy in me was a proud misanthropy, a certain acrimony against the rich and happy of the world as though they were so at my expense, as though their alleged happiness had been usurped from mine." In another one of his works he also began by saying, "Let us begin by setting aside all the facts." Unfortunately, this approach to public policy has an all too current ring.

There are different views on the function of the tax system and the role of progressivity. According to one side of the argument, the tax code, in raising revenue, should additionally be used to alter the after-tax distribution of income. In other words, the tax code should be an instrument of social policy to redistribute income in a way deemed desirable by politicians and bureaucrats in Washington.

Another view sees the tax system principally as a device to raise revenue to finance needed public goods with a minimum of interference with the private sector. Attempts to manipulate income shares using the tool of tax policy mainly serve to drive the rich into tax shelters. As a result, middle and lower income taxpayers are forced to assume more of the tax burden. In other words, while some may feel good about "soaking the rich" with a high

¹⁰ An earlier version of this chapter was released by Senator William Roth as a Republican JEC staff study.

statutory tax rate, this rate will not in reality be paid, since it can readily be avoided through legal use of tax shelters. More of the revenue burden will consequently fall on others. Conversely, by reducing excessively high tax rates, the tax burden can be shifted in a way that may be considered progressive.

Historical experience supports the argument that reduction of very high tax rates can generate increased revenues from upper income groups. As noted in The Economist, this has occurred in the United Kingdom after tax cuts in 1979, and in the United States since 1981. According to this publication, "Across the world in recent years, a reduction in top rates of tax has quickly resulted in higher, not lower, yields to the exchequer."¹¹ A number of studies and reports have also documented similar results from the Mellon (1921, 1924, and 1926 tax cuts)¹² and the Kennedy tax cuts of 1964. Following both tax cuts, rapid growth in the Adjusted Gross Income (AGI) reported by upper income groups increased both the tax payments and tax burden share of the wealthy.¹³

In retrospect, it is remarkable that in all the discussion about the distributive fairness of the 1981 and subsequent tax legislation the IRS data¹⁴ on actual tax payments have not been used more widely. While simulations and projections of tax payments are widely employed, the actual data are virtually ignored. Yet these data show the income tax trends during the 1980s very clearly. These IRS data are organized by income percentile, and tax payments of various segments of the population are easily identified.

As Table III.1 below shows, the average income tax payments of the top 1 percent of taxpayers (those with AGI over \$157,136 (1988 cut-off)), adjusted for inflation, jumped 51.3 percent between 1981 and 1988. Meanwhile, the average tax payments of the top 5 percent (AGI over \$72,735, including the top 1 percent) also increased, and those of the middle (AGI between \$18,367 and \$72,735) and lower (AGI below \$18,367) income taxpayers declined 18.0 percent and 25.7 percent, respectively.

¹¹ The Economist, (March 19, 1988), p.54

¹² Annual Report of the Secretary of the Treasury, 1927 (Washington: U.S. Government Printing Office 1928), p.26.

¹³ James Gwartney and Richard Stroup, "Tax Cuts: Who Shoulders the Burden?" Economic Review: Federal Reserve Bank of Atlanta (March 1982), p.21.

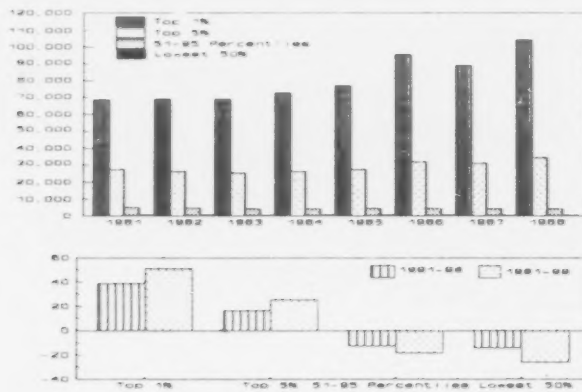
¹⁴ Internal Revenue Service, unpublished data, compiled annually by Statistics of Income Division.

Table III.1
Average Income Tax Payments,
by Taxpayer Group (1988 dollars)

Year	Top 1%	Top 5%	51-95 Percentiles	Lowest 50%
1981	\$68,725	\$27,415	\$4,995	\$583
1982	68,977	26,199	4,553	533
1983	68,899	25,272	4,187	486
1984	72,723	26,161	4,184	507
1985	76,750	27,296	4,227	504
1986	95,462	31,896	4,377	500
1987	88,685	31,022	4,068	438
1988	104,008	34,446	4,097	433

Percent Change				
1981-86	39.0%	16.3%	-12.4%	-14.2%
1981-88	51.3	25.6	-18.0	-25.7

Source: IRS and JEC Republican Staff.



These data support the view that the reduction of high marginal tax rates can increase the realization of taxable income by upper income persons enough to enlarge their tax payments. According to this view, a reduction of tax rates lessens the incentive to avoid the realization of income and to use tax shelters, thus boosting measured income and tax payments. In contrast, opponents of the 1981 act had argued that it was a "giveaway to the rich"

which would reduce the tax payments of high income taxpayers, and so shift more of the tax burden onto low and middle income taxpayers. Again, it is clear that this is not what happened.

Of \$411.8 billion in personal income taxes collected in tax year 1988, \$113.2 billion, or 27.5 percent, was contributed by the top 1 percent of taxpayers. In other words, one fourth of all personal income tax revenues came from the richest 1 percent of taxpayers, and 45.5 percent was derived from the top 5 percent. As Table III.2 below shows, the personal income tax burden has been shifted since 1981, but the shift has been upward onto higher income taxpayers. The share of the income tax burden borne by the top 1 percent has jumped by 56 percent since 1981.

Table III.2
Income Tax Burden Shifted Towards Wealthy

Year	Top 1%	Top 5%	51-95 Percentiles	Lowest 50%
1981	17.6%	35.1%	57.4%	7.5%
1982	19.0	36.1	56.5	7.4
1983	20.3	37.3	55.5	7.2
1984	21.1	38.0	54.6	7.4
1985	21.8	38.8	54.1	7.2
1986	25.0	41.8	51.6	6.6
1987	24.6	43.1	50.8	6.1
1988	27.5	45.5	48.7	5.7

Source: Internal Revenue Service.

As the share of the personal income tax burden shouldered by those with the highest income has increased, that of the middle and lower income taxpayers has declined. By 1988 the bottom 50 percent of taxpayers bore only 5.7 percent of the income tax burden, and this does not count those entirely removed from the tax rolls during the 1980s. The statistical evidence refutes the view that the lower income taxpayers have been saddled with a higher income tax burden in the 1980s.

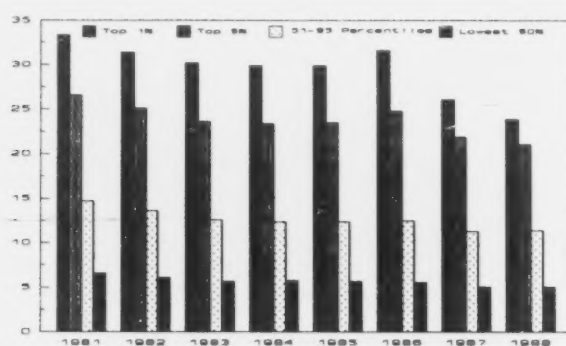
Tax Rates

Another way to review tax trends is the analysis of effective income tax rates (income tax payments as a percentage of AGI). Table III.3 illustrates the impact of the 1981 and 1986 tax legislation on the effective tax rates of various groups of taxpayers. Under Kemp-Roth, the largest reduction in effective tax rates was for lower and middle income taxpayers. Between 1981 and 1986 under Kemp-Roth, low and middle income taxpayers have had

declines in effective income tax rates amounting to 15.2 percent and 15.0 percent, respectively.

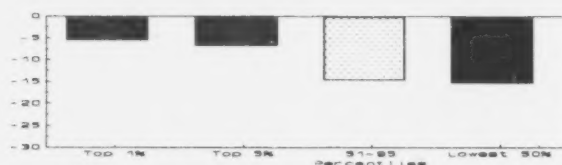
Table III.3
Effective Income Tax Rates
by Taxpayer Group

Year	Top 1%	Top 5%	51-95 Percentiles	Lowest 50%
1981	33.4	26.6	14.7	6.6
1982	31.4	25.1	13.6	6.1
1983	30.2	23.6	12.6	5.7
1984	29.9	23.4	12.4	5.8
1985	29.9	23.5	12.4	5.7
1986	31.6	24.8	12.5	5.6
1987	26.1	21.9	11.3	5.1
1988	23.9	21.1	11.4	5.1



Percent Reduction Under Kemp-Roth (1981-1986)

1981-86	-5.4	-6.8	-15.0	-15.2
---------	------	------	-------	-------



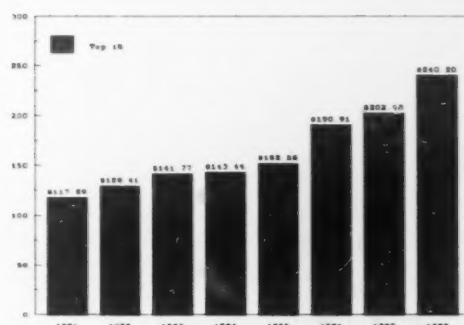
Source: Internal Revenue Service and JEC Republican Staff.

Fairness Ratio

The change in tax payments, tax burden, and effective tax rates can also be expressed in terms of the average tax payment made by a representative of the top 1 percent of taxpayers per dollar paid by each taxpayer in the bottom 50 percent. This ratio, called here the "fairness ratio," reflects the relative contributions of the two taxpayer groups. In 1981 a taxpayer in the top 1 percent paid \$117.89 for every dollar paid by each taxpayer in the bottom half. By 1987 this had jumped to \$202.48, and by 1988 to \$240.20.

Table III.4
Fairness Ratio*
in Tax Payments

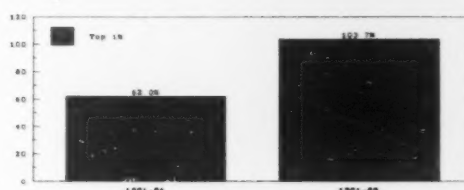
1981	\$117.89
1982	129.41
1983	141.77
1984	143.44
1985	152.28
1986	190.91
1987	202.48
1988	240.20



Percent Change

1981-86	62.0%
1981-88	103.7%

*Average tax payment of taxpayer in top 1 percent for each dollar of tax paid by each taxpayer in the bottom 50 percent.



Source: JEC Republican Staff.

Obviously the increase in the fairness ratio could not result from falling tax payments by those with the highest incomes unless the tax payments of the bottom half were falling even faster. However, as shown in the previous tables, the change in the fairness ratio is due to the sharp increase in the real tax payments of the upper income taxpayers while the real tax payments of the middle and lower income taxpayers declined.

The IRS data establish that the changes in the personal income tax over the last 10 years have shifted the tax burden in a way most would consider very progressive. It is true that some lower income taxpayers have experienced some increase in taxes in recent decades. However, it is essential to examine each feature of the tax code separately to determine the source of this increase. Such an examination shows that changes in the personal income tax law are not the source of this result; in fact, according to other data, the bottom fifth of taxpayers does not incur any positive income tax liability. The largest single legislative change leading to regressive tax increase for some taxpayers has been the signing into law of large phased-in payroll tax increases by President Carter. From 1977 through 1990, the social security payroll tax rate rose by nearly a third, from 11.7 to 15.3 percent.

Advocates of tax rate reduction argued that a cut in high marginal tax rates would tend to draw more income into the taxable economy. Those affected by the highest tax rates would respond to lower rates by generating more taxable income and tax revenue. High income Americans seem to have responded to the tax incentives after 1981 by generating more taxable income and tax revenues, and their share of the tax burden has increased. But with a reduction in marginal tax rates, the real income gains of middle and lower income Americans, less affected by changes in tax avoidance, have resulted in lower real tax payments and tax burden.

Review of the statistical record offers no support for the contention that the personal income tax burden has been shifted from the rich to others; the movement has been in the opposite direction. While there have been regressive tax changes implemented through social security legislation in the late 1970s, changes in the personal income tax structure have had the opposite effect.

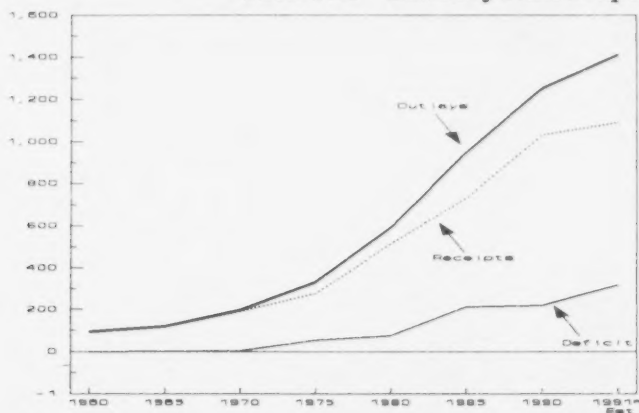
Chapter IV

THE FEDERAL BUDGET

Federal spending is projected to increase from \$1.25 trillion in 1990 to \$1.39 trillion in 1991, a rise of \$140 billion according to CBO. Federal revenues will grow \$63 billion in fiscal 1991 to an all time high of \$1.09 trillion. Since the rise in outlays exceeds that of revenues by such a wide margin, the deficit will surge to a record level of \$298 billion in 1991.

This marks an unfortunate deterioration in the fiscal condition of the federal government since 1987-89 when the deficit was in the \$150 billion range. Between fiscal 1987 and 1991 federal revenues will jump \$240 billion, while outlays will grow by an even larger amount of \$387 billion. Despite the ongoing fiscal problem evident during this time, spending continues to spiral upward. Table IV.1 shows the growth of federal government spending, revenues, and deficits since 1960.

Table IV.1 -- Runaway Federal Spending



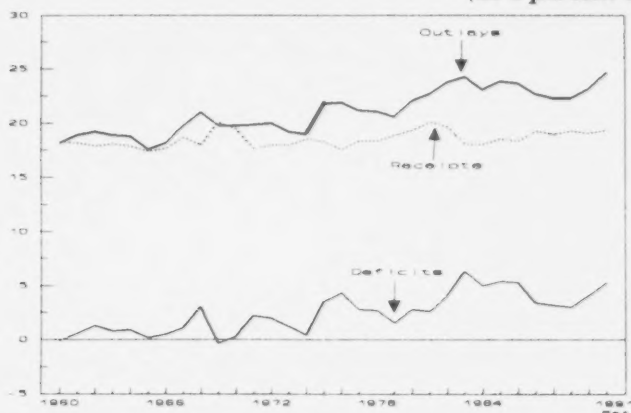
Nor is the fiscal situation going to be much better in fiscal 1992. Though revenues are projected to increase by \$76 billion, federal spending is expected to increase by at least as much, so no reduction in the federal deficit is expected. This is the highest level of deficit spending in U.S. history.

Despite attempted rationalization, there is no excuse for \$300 billion in congressionally sanctioned deficit spending.

The current deficit problem has been attributed to the recession, the S&L bailout, the war, and other temporary factors. However, when one passing cause of large deficits recedes, others become available to justify high deficit spending. The supporters of continued expansion of government already have a long laundry list of such proposals. For this reason, the deficit problem will never melt away by continuous resort to tax increases. A report issued by Senator William Roth several years ago demonstrated that Congress spends \$1.58 for every dollar of new taxes. Higher taxes merely fuel additional federal spending, undermine the economy, and actually push the deficit higher. The revenue level is already the highest in U.S. history, and the deficit is also at a record high.

Furthermore, the ratio of taxes to GNP is already above the postwar average, which is very high by historic standards. As Table IV.2 indicates, the rise in the revenue as a percentage of GNP has been outpaced by that of spending, which in fiscal 1991 is 25 percent. As a result, the deficit as a percentage of GNP has jumped sharply since 1989.

**Table IV.2 -- Government Grows as a Share of the Economy
(as a percent of GNP)**



As Republican Members of the Joint Economic Committee (JEC) have pointed out repeatedly in previous Annual Reports, unless spending growth is restrained, the deficit will continue to be a problem. Deficits may wax and wane, but they will remain too large so long as spending is out of control.

The idea that undertaxation is the source of the deficit was dismissed recently by Gary Becker¹⁵, the eminent economist who developed the concept of human capital:

With taxes taking such a large share of GNP, the perception in Congress and the media that the budget "crisis" is attributable to insufficient taxation is hardly credible. Rather, government revenues are misallocated, with too much spent on bad programs and not enough attention paid to designing essential ones....Is it any surprise that governments are so ineffective at what they should be doing when they are doing so many other things too?

Budget Outlook

The recent budget agreement does contain procedures designed to cap the spending growth of discretionary spending and limit unfunded expansion of entitlement spending. However, it remains to be seen how effective these procedures will be. Advocates of higher spending have already watered down scorekeeping provisions in the House. The spending caps for nondefense discretionary spending were set high enough to accommodate a surge in these outlays, so it is hard to believe these will ensure fiscal discipline. The caps are not a strong constraint, and it remains to be seen whether even these caps will be retained over the full course of the agreement.

Nonetheless, the official budget projections of CBO and OMB show light at the end of the deficit tunnel. If all goes well, the deficit will fall to a still excessive level of \$135 billion in fiscal 1996, according to CBO. However, this is based on the idea that the discretionary spending caps will work as intended. It assumes that the "pay as you go" provisions will not be manipulated by partisans, and that assets held by the Resolution Trust Corporation will bring revenue into the Treasury in later years, reversing the presently huge outlays for savings and loan resolutions.

Whereas previous budget forecasts may have been made rosy by unrealistic economic assumptions, current projections rely on extremely optimistic policy forecasts. As Milton Friedman has pointed out, congressional spending is constrained only by the level of expected tax revenues plus the maximum politically acceptable deficit. The impact of new budget rules has to be evaluated in the context of how Congress actually operates, not on the basis of unrealistic wishful thinking.

¹⁵ Becker, Gary S., "Your Tax Dollars Are At Work--On the Wrong Jobs," Business Week, November 26, 1990, pg. 18.

The "pay as you go" provisions supposedly will permit added entitlement spending only if funded by new taxes or entitlement spending cuts. Any new entitlement spending or tax cuts which are not "paid for" will result in a limited sequester within entitlement accounts. The actual effect of these provisions make "tax as you go" a more accurate description of how these provisions will influence Congress. The likelihood of cutting one entitlement to pay for another is extremely remote, so the effect of this so-called "constraint" is to increase already intense pressures for higher taxes. Congress has historically supported entitlement spending above revenue levels, and "pay as you go" is more likely to result in higher taxes than restrained spending.

Under these rules, a congressional majority could make virtually irreversible commitments to expand entitlement spending, and only later confront Congress with a *fait accompli*: taxes must be raised to reduce the deficit increased earlier in the session. This is just a mechanism for automatic tax increases justified by earlier fiscal irresponsibility.

Under these new rules, the Congress would essentially be voting very specific benefits to very specific groups at no apparent cost. Only at the end of each session would Congress determine the unlucky taxpayers who would foot the bill. Thus the cost of new spending would be shifted, probably in obscure ways, to politically vulnerable taxpayers. Historically, it has been the middle class, where the money is, which foots the bill.

Thus the budget outlook remains troublesome. Though official CBO projections show declining deficits, after 1992 there will be no progress until spending is brought under control. Improvement in the budget situation always seem to be projected just over the horizon, only to melt away as the promised land nears.

New Rules are Needed

As we have pointed out in previous reports, public choice theory explains how the combined influence of special interest groups can pressure Congress to satisfy spending demands regardless of the level of available revenues. Unless special rules are in effect, the spending decisions of democratic institutions may be made without adequate consideration of their cost. This inability to adequately consider cost biases legislatures towards support of added spending. This problem has been referred to as fiscal illusion.

Real institutional constraints are needed to force Congress to evaluate new programs on the basis of costs and benefits. Abandoning baseline concepts, considering constitutional provisions to limit taxing, spending, and

deficits and to require supermajority approval of appropriations measures are among the available options.

Of course, many programs fail to cover their financial costs. The mission and purpose of the government activity may be undefined or unclear. To remedy this shortcoming, Senator Roth has introduced a bill to implement performance budgeting in government, and the President has endorsed this concept in his budget submission. The idea is to define as precisely as possible the mission of an activity, how this can be measured operationally, and the means most suitable for accomplishing program objectives. In this way an expenditure can be linked to specific results, and their achievement or lack thereof can form the basis for subsequent budget decisions.

Another problem is that the financial costs of funding a new government expenditure do not fully measure the costs to society generated by higher spending. An additional excess burden is imposed by the economic losses caused by the financing of the new expenditure. For example, higher taxes not only can raise revenue, they also can induce workers to work less or savers to save less. The lower work effort and saving also impose a loss to society over and beyond the revenue cost associated with increased spending. Current estimates of the excess burden range up to half of each dollar of revenue cost. In other words, a new government activity would need to create \$1.50 of benefit to society for every dollar of outlay to cover its total costs.

Realism and Government Policy

The overall size of government has made it unwieldy, bureaucratic, and obtrusive. The size and scope of government gradually has forced its way into every corner of private life. For example, the burden of taxation alone limits the ability of Americans to choose where they want to live, educate their children, cover medical costs, save for retirement, and live in peaceful enjoyment. In myriad ways, the most personal and private decisions are unduly influenced by the intrusive presence and regimentation of government.

The erosion and crowding out of other social institutions by the State are bad enough. But the enormous size of government has made it impossible for it to perform even its legitimate functions well. It is unable to manage its own financial affairs, its programs are often ineffective or counterproductive, and it is grossly inefficient. Increasingly, policy decisions are determined by special interest groups drawn to government largesse.

This exploitation of unlimited government is as natural as it is corrupting of democratic institutions. When the Congress has the power to divert billions in special benefits to favored groups, it is unavoidable that the

integrity of democratic institutions will be undermined. While dealing with the symptoms of the problem is tempting enough, nothing short of limiting this activity by limiting the scope of government will prove sufficient. The intellectual basis for belief in the omniscience and goodness of expansive government has collapsed in recent years. However, the practice continues.

Not so many decades ago many believed that government officials had superior knowledge and motives relative to those in the private sector. Officialdom could guide the economy by manipulation of fiscal policy and other policy instruments. Discretionary fiscal and monetary policies were viewed as tools of macroeconomic policy through which government officials could guide the economy to desired levels of income, output, employment, unemployment, and inflation. Fine tuning by government could correct the deplorable mistakes made by private interests acting out of ignorance or self-interest. However, this approach to policy failed spectacularly in the 1970s, a development which changed the intellectual environment.

In the last two decades, Nobel prizes have been awarded to two economists who emphasized the limitations of government action, F.A. Hayek and James Buchanan. Government officials, they explained, have neither superior knowledge nor motives necessary to manage an entire economy. F.A. Hayek titled his Nobel lecture "The Pretense of Knowledge," alluding to the hubris of those who made policy by assuming they knew more than they actually did. While there is a legitimate role for government, the reality of government failure is at least as great as market failure. The point is not that government officials are especially venal, but simply that they are no more virtuous or knowledgeable than anyone else. A small group of officials has no way of replacing the vast amount of knowledge used in a market process from their own limited stock of knowledge.

Meanwhile, the common sense of average people has also reached the same conclusion. Presumption is not a sound basis for policy. Government cannot solve all problems or accumulate all the knowledge dispersed throughout a market economy. Its attempts to do so have created untold tragedy over the last two centuries.

This attitude marks a return to the wisdom of the Founders expressed in the Federalist Papers by James Madison. As *The Federalist* No. 51 states, "If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary." The acknowledgement that public officials need to be constrained by rules to protect the public interest is now accepted everywhere outside of Washington, D.C. and self-styled elites. Something basic is wrong with a Congress that operates as its actions are literally out of control.

Chapter V

**PRINCIPLES OF A MORE THOUGHTFUL
DOMESTIC POLICY**

A unique opportunity currently exists to examine and restructure how domestic programs affect individual economic independence and social opportunity. Uninterrupted growth since the early 1980s, coincident with the inauguration of a Republican Administration, has largely been the result of implementing policies that rely on market forces to improve economic conditions. The advantages of such policies -- larger and more broadly distributed than is widely understood -- are outlined elsewhere in this Report.

Recent U.S. economic policy has generally moved toward a dispersal of economic concentration and authority -- lower taxes on a broader base and a monetary policy with the objective of price stability rather than a doomed attempt to manage GNP growth or interest rates. The benefits to society of these policies are obvious. Yet not everyone is sharing in this economic progress. Too many Americans are not full participants in the economy, and too many domestic programs do not work as they are intended.

Governments at various levels are responsible for operating schools that work, maintaining a healthy economy, preventing crime and assisting those who find themselves in need. Yet every day, Americans see schools that don't teach and children that cannot or do not learn. Our constituents see health care that is too expensive and services that are chaotic. Streets are not safe, even in the daytime, and criminals appear to run rampant. Public housing is neither safe, sound, nor sanitary, and residents fear for their lives when they leave their homes.

The agenda for the 1990s must be to implement policies that will address these programmatic failures, building on our knowledge gained from mistakes of the 1970s and successes of the 1980s. The presence of a huge fiscal deficit and debt, and the failure of budget "summit" agreements to be fully implemented or produce the amount of deficit reduction promised, makes it both necessary and pressing that we reexamine the domestic agenda to better serve the American people.

The opportunity for a new approach is also available because there is a wide consensus over national goals. A part of that consensus forms around the picture of American society. All of us support a highly educated workforce to enhance American productivity and living standards. Each of us

recognizes the benefits of adequate housing and meeting other immediate physical needs, the need for safe communities, a secure retirement, and a clean environment. All of us recognize the goal of equality among persons of different race, gender and age.

Another part of that consensus is organized around the size of government. The 1970s exposed the reckless and naive march toward a U.S. welfare state. The excesses of these mostly well-intentioned policies collapsed during that period under hyper-inflation, staggering unemployment, and surging average tax rates. The credibility of government institutions to manage economic growth and distribution plummeted and has not recovered since. In a November 1990 Harris Poll, for example, only 12 percent of Americans professed a great deal of confidence in Congress as an institution.¹⁶ This is the lowest level of public confidence in Congress since 1976. Polling data also shows decreased public faith in other government institutions to manage political and economic problems. The public strongly questions the national government's ability to manage the economy or address important social needs.

Voters are obviously and justifiably frustrated by the failure of a monopolistic national government. Remarkably, in the face of this frustration and failure, policymakers tend to "blame the victim" -- the taxpayer -- in pursuit of ever higher rates of taxation. This failure by government to take seriously public frustration results in expanding or resurrecting already discredited programs, further increasing public dismay and creating a vicious cycle of cynicism toward government.

One should not regret that bureaucratic efforts to manage the economy have lost their credibility. What is regrettable is that public support for national policy makers may be so low that policy redirection is impossible. Elected officials should hope that is not true. Rather, it is possible to see this public skepticism toward the national government as an opportunity to more clearly define the federal role in policy areas such as economic growth, family income distribution, and individual economic opportunity.

Americans will be receptive to a systematic reform approach that avoids the mistakes of the past. Raising taxes in the hopes of making current bureaucratic programs work better is a failed approach.

Policymakers informed about economic principles know that there is a sound basis for much analysis under the "empowerment" label, which advocates returning economic and social decisions to the "lowest competent

¹⁶ The Harris Poll. "Confidence in Business and Government Declines," #51, 16, December 1990.

unit" -- those who are affected. As Dr. Stuart Butler has described it, an empowerment approach is "trusting ordinary people rather than a paternalistic welfare state to make economic decisions." The JEC can contribute to a full examination of this perspective. To that end, the following principles are suggested for a new perspective for addressing domestic social needs.

The first principle is the strength of decentralization. Our national diversity and creativity generates opportunities for new ideas and experiments that can never emerge in a highly centralized bureaucracy. The genius of federalism is that it provides an opportunity for government to experiment on a small scale before it proposes national reforms. Supreme Court Justice Louis Brandeis summarized this genius in remarking that "a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."¹⁷ Decentralization helps both to nurture sound ideas and to weed out failures. A centralized system stresses uniformity and process while punishing innovation and retarding self help.

Congress needs to encourage the dispersal of program direction to local and state governments or the private sector. Financing and decision-making need to be shared between federal, state, and local entities, permitting state and local governments to design programs to fit their populations. Decisions that are more appropriately made by local and state communities should not be usurped by the federal government. But the federal government may hold state and local institutions accountable for effective delivery of services, particularly those supported by federal funds, while allowing flexibility in implementation.

The second principle is the advantage of incorporating a market orientation into government policies. Social programs should enable individuals and communities in ways that enforce the mutual obligations and responsibilities of individuals, families and what Tocqueville more than a century and one half ago called "voluntary associations." An individual should be expected to take advantage of available opportunities for education and employment, to obey the law, and to nurture his or her children into responsible citizenship. Public programs should seek to give individuals greater control over their own lives, enhancing personal choice and dignity. A stronger emphasis on choice and responsibility can foster the values that are central to economic self-sufficiency.

¹⁷ Quoted in Chapter 5, "Advancing States as Laboratories," Budget of the United States Government: Fiscal Year 1992, 147.

Congress needs to rely less on government bureaucracies that intrinsically limit individual choices and vest power in agencies and bureaus. Reversing this flow of power results in greater individual economic ability and fewer regulatory mandates -- enhancing incentives for work, saving, investment, educational quality, and family stability.

A third principle is the compatibility of strong economic growth and a "fair" economic resource distribution. Economic growth is the only way to expand the economic pie so that the level of income will rise for all groups. It is counterproductive to pursue income distribution policies that focus on a supposedly "fair" division of a shrinking economic pie divided among an increasingly needy public. Social programs must be redesigned to work in concert with, rather than against, market forces. Given scarce resources, we need to review whether existing programs are targeted on those who need them most.

The fourth principle is to focus on "what works" to produce desired policy results. The measure of success is not the level of federal appropriations but rather whether it produces improved practical results. The bureaucratic impulse is to corrupt the noble concept of the government of persons into the degrading practice of the administration of things. Depersonalized people, compartmentalized needs, limited choices, and segregated effort are the ubiquitous and unavoidable characteristics of bureaucratic systems. These command-oriented policies subsequently fail to "solve" the problem at which they are targeted. Unfortunately, system failures are not blamed on program design, but rather on insufficient funding or even on the recipients themselves.

Many public housing authorities (PHAs) are disappointing example of past and current policy failures. While most of the over one million dwelling units are well operated and maintained, serious problems continue to exist in our nation's largest PHAs who provide the worst possible shelter to poor people that have virtually no other housing alternatives. Of the 23 PHAs currently identified as "troubled" by HUD, containing 250,000 housing units, vacancy rates typically exceed 6 percent even though HUD operating subsidies run as high as \$7,000 per unit per year.

At the present time there are approximately 11,000 qualified persons on waiting lists for public housing within the District of Columbia. At the same time, there are an estimated 2,400 vacant public housing units under the jurisdiction of the Department of Housing and Community Development. Many of these vacant units need repair and federal funds for repairs are available for the asking from the U.S. Department of Housing and Urban Development. Only an inefficient D.C. bureaucracy prevents a major reduction in homelessness and inadequate housing. Evidence exists to

conclude that this example is not an exception, questioning the presumption that inadequate funding is the only culprit in the affordable housing problem.

No one needs or wants to be broken out of the dominant perspective more than poor and disadvantaged persons. As Kimi Gray, a former welfare mother, Chairperson of the Kenilworth-Parkside Resident Management Corporation put it, "we were programmed to be dependent [but] by empowering residents, we've changed attitudes." Indeed they did. Kenilworth-Parkside, a resident-managed public housing project in Washington, D.C. recently became the first such development in the nation to be sold to the residents.

Resident involvement, management, and ultimately ownership of public housing units is the embodiment of the empowerment perspective. Poor people are not to be treated as just mouths to feed and bodies to shelter; they are entitled to what Martin Luther King, Jr. called a stake in the American dream and the opportunity to build a better future for themselves and their children.

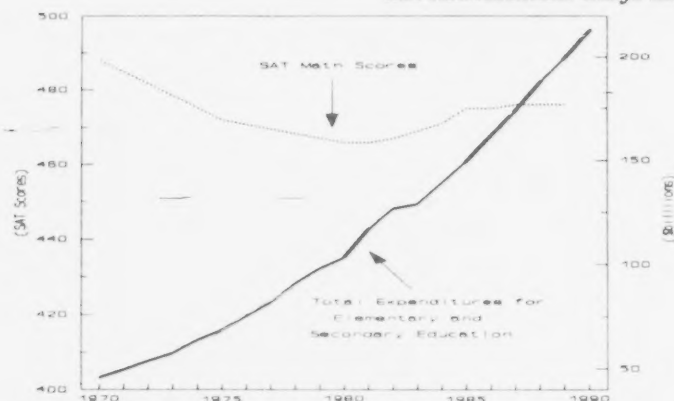
The 1990 National Affordable Housing Act expanded the empowerment perspective by including President Bush's comprehensive HOPE -- Homeownership and Opportunity for People Everywhere -- agenda. The thrust of HOPE, in addition to increasing home ownership opportunities for low- and moderate-income households, is to create jobs and entrepreneurial activity in America's distressed urban and rural communities.

The argument presented here is not to seek total federal withdrawal from the domestic policy agenda. On the contrary, it is the starting point for an approach that can address our unmet domestic needs. Recognizing why past policies failed permits us to build on stronger policy foundations. Making progress on key domestic concerns -- economic growth, a sustainable environment, quality education, improved health care, and broader worker safety -- may be described as a choice between the failure of the old and the promise of the new.

Reforming American education remains a critical need. Increasing educational excellence is vital to the economic well being of individual Americans and of the nation as a whole. Education plays a critical role if we are to maintain our dominant position in international trade, where high technology is an increasingly important factor. As President Bush noted in his budget presentation, the United States spends more per student on education than almost every other country. Yet the average performance of American elementary and secondary school students on internationally administered tests is well below average.

A major new study confirms earlier effective schools research by James S. Coleman¹⁸ at the University of Chicago and offers a powerful endorsement of educational choice. Brookings senior fellow John E. Chubb and Stanford University Professor Terry M. Moe find the organizational structure of public school systems is a major roadblock to improving American education.¹⁹ Government reforms have failed because government is the problem. Chubb and Moe advocate radical restructuring of public education, by deregulating both the supply and demand for education through competitive markets and parental choice. States and localities that have introduced choice options -- Milwaukee, Wisconsin; New York City; Richmond, California; and the states of Minnesota and Washington -- have experienced marked improvements in educational attainment. The authors conclude choice *is* a panacea -- one that lawmakers should embrace as the answer to the failure of American education. Clearly, this is an area that deserves congressional attention.

**Graph V.1 -- Education Spending Rises,
but Achievement Stays Level**



Source: The World Almanac and Book of Facts, 1991, pg. 213, and CRS: U.S. Department of Education: Major Program Trends, Fiscal Years 1980-1990.

¹⁸ See, for example, James S. Coleman, "The Evaluation of Equality of Educational Opportunity," in Frederick Mosteller and Daniel P. Moynihan, eds., On Equality of Educational Opportunity (New York: Vintage Books, 1972).

¹⁹ John E. Chubb and Terry M. Moe, Politics, Markets, and America's Schools, (Brookings: Washington, D.C., 1990).

Health care is another area where a new perspective is needed. Health care expenditures are an ever rising portion of federal expenditures and a growing burden for employers and families across the nation. At the same time, access to health care remains a problem for many families and individuals. Our nation spent \$666 billion for health care in 1990, with cost increases outpacing the inflation rate.²⁰ Despite this flood of funds, our health care system works poorly for far too many Americans. As many as 37 million Americans lack health insurance, and lack of access to health care remains a problem for many individuals and families.

Many of the structural flaws in the nation's health care system developed as a direct result of the complex set of federal tax and expenditure policies that seek to remove the demand and supply of health care from the order of the market. More bureaucratic tinkering such as mandating private sector coverage or imposing price controls will further exacerbate the health care problem, generate a loss of jobs and contribute to business closures.

An alternative approach is to enhance market mechanisms for all health care purchasers. Individuals who currently receive government subsidized health care have little control over the services they receive. The creation of a Health IRA, for example, would funnel federal dollars to patients rather than to hospitals and doctors and enhance individual choice. Empowering individuals to select health care services would introduce greater market competition, increase the number and types of providers, and reduce health care costs while improving health care services.

Insights from market-based economics can also be used to encourage socially responsible and cost-effective environmental policies. Last session's Clean Air Act reauthorization created marketable pollution permits to allow business and industry to exchange emission credits. The anticipated \$30 billion additional cost of the Clean Air Act is high, but it would be larger without such market incentives. Future environmental efforts should more fully rely on market mechanisms to achieve maximal environmental benefit at minimal economic cost.

Employment and more jobs should be the central objective of a new domestic economic agenda. Government must continue to promote and sustain a healthy, growing economy, for aggregate economic growth and general economic well being are the primary interests of elected national officials.

²⁰ Constance Matthiessen, "Many Acknowledge Change is Needed, But Few Agree on Its Form," *Washington Post Health*, December 4, 1990, pg. 9

The Congress should not spread itself too thin by contemplating a detailed domestic policy agenda. But past bureaucratic, control-oriented domestic policies prevalent in the 1970s ignored many insights made available by recent breakthroughs in economic theory. Mistaken policies failed to achieve either sustained economic growth or more equitable resource distribution. Only when these mistaken policies were trimmed back did economic growth revive. Only a new perspective on domestic policy, informed by recent economic and public choice insights, will prevent us from repeating the mistakes of the past.

Chapter VI

MONETARY POLICY

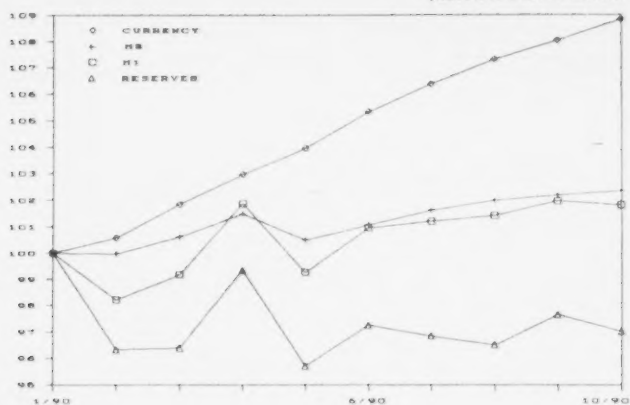
In early 1991 the Federal Reserve System moved aggressively to ease monetary policy. This action would seem to be an appropriate response to the fourth quarter 1990 and preliminary first quarter 1991 economic data. Since early spring 1990, M2 growth rates have declined from approximately 7 percent to less than 4 percent on an annualized moving average basis. During the same period, M1 has been almost steady at 4 percent growth on an annualized moving average basis.

These rates of money growth are lower than reported price level increases during the same period, so some would say that slow money growth may have been constraining real growth rates during 1990. On the other hand, both M1 and M2 as measures of the money supply are at any point in time simultaneously measures of the demand for bank services (deposits, certificates, loans, etc.), and a slowing economy would naturally reflect an endogenously slowing growth in the demand for bank services.

The issue, therefore, is whether the Federal Reserve and other bank regulatory agencies share some responsibility for constraining the money supply and contributing to the economic slowdown; or whether the economic slowdown is due to real factors unrelated to monetary policy.

The anomaly among monetary aggregates has been the monetary base, which has been growing at a steadily increasing rate during 1990, except for a brief period of tightening in the late summer and autumn (subsequently reversed). Because of the growing perception that difficulties in the banking system are widespread during the current period of economic weakness, the suggestion has been made that the Federal Reserve might be "pushing on a string." This colloquial phrase in monetary theory describes a situation in which loan demand is so weak, or quality loan opportunities so few, that bank officers fail to increase their lending activity in response to an increase in the supply of free reserves. If this has been happening, then it is the banks themselves -- not the business community, demanding loans at a slower rate, nor the monetary authorities, making policy too restrictive -- that account for slow M1 and M2 money growth.

**Graph VI.1 -- Real Growth of Monetary Aggregates
(Index June 1989 = 100)**



As Graph VI.1 shows, currency has been growing at a significantly faster rate than any other measure, including bank reserves. But the monetary base consists of bank reserves plus currency. If the currency component of the monetary base is removed from the total, the remainder -- bank reserves -- have not been growing noticeably faster than the other monetary aggregates. This interpretation of the monetary data does not support the "pushing on a string" theory.

In the current business downturn, it is far too early to reach any conclusions about the behavior of the banking system as a contributing factor. In the first place, a study of the public's demand for currency published in the Federal Reserve Bulletin of February 1986 suggested that a substantial portion of U.S. currency was exported to meet foreign demand for hard currency. The opening of the Berlin Wall and Eastern Europe at the end of 1989 might explain the surge in demand for U.S. currency, which could make the monetary base grow faster than M1, M2, or even the level of domestic bank reserves.

What is of interest in monetary policy, of course, is the effect it has on the real sectors of the economy. The reason why economists are interested in measures of the money supply is that there is an established, long-term relationship between rates of growth in these monetary aggregates and the rates of growth in nominal gross national product.

Yet, because the velocity of money reversed its post-World War II trend in the decade of the 1980s, and began to decline, the reliability of the rate of increase in the monetary aggregates as a predictor of inflation rates and growth rates for nominal gross national product has been questioned. Increasingly economists have returned to studying interest rates for relationships between monetary policy and economic growth. During 1989-90 there was some discussion in the press and among monetary economists about a "flat yield curve" strategy at the Federal Reserve. The Swedish economist, Knut Wicksell, had advocated during the 1930s that central banks follow a strategy of manipulating short-term market interest rates to keep them approximately equal to the longer term market interest rates. The idea is based on the view that long-term interest rates are more dominated by inflationary expectations, and short-term rates directly impact on the tightness or ease of monetary policy.

If long-term rates are rising, for example, the market would be sending the signal that inflationary expectations were rising, and for the central bank then to raise short term rates would tighten monetary policy and dampen the inflationary pressures. The "flat yield curve strategy" is therefore almost an automatic policy for stabilization. If inflationary expectations are absent, or if declining prices are in prospect, and long-term interest rates are declining, then lowering the short-term interest rates to ease monetary policy would be appropriate.

There is evidence the Federal Reserve was experimenting with this technique during 1989 and 1990. While interest rates peaked in March 1989, the gap between interest rates on the 3-month Treasury bill and the 10-year Treasury note progressively narrowed throughout 1988-89. The gap between interest rates on the 10-year Treasury note and the 30-year Treasury bond not only narrowed throughout this period, but for 13 months the 30-year bond had a lower interest rate than the 10-year Treasury note. From December 1988 until July 1990, the gap between the 3-month Treasury bill and the 30-year Treasury bond was less than 100 basis points.

The "flat yield curve strategy" has some intuitive appeal as a way of conducting monetary policy by using financial market price indicators. The techniques for controlling monetary aggregates that would have been optimal during the 1960s and 1970s, in retrospect, for example, would not have been very good during the 1980s as the velocity of money was changing in an unpredictable way. Economists now understand that the velocity of money can be stable for long periods of time, as for example in the post-World War II era when inflation was low and gradually increasing, and financial services were hardly as global in scope or as innovative as in the most recent decade. But by the same token, monetary velocity can become quite erratic in

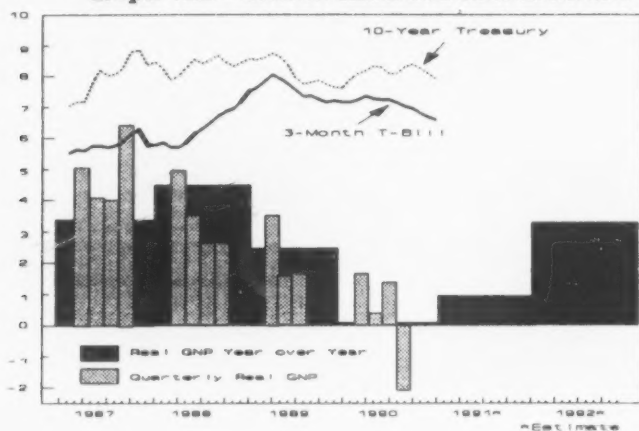
response to volatile interest rate reversals and sharp declines in the rate of inflation, as the United States experienced in the 1980s.

Any theoretical technique for permanently controlling inflation, however, must be administered by real people in a real world environment. At the same time as the Federal Reserve was concentrating on managing long-term inflationary expectations, the real estate market collapsed in some sectors such as Texas, and then in New England and Mid-Atlantic states, sending shock waves throughout the economy. Did the conduct of monetary policy during the 1989-90 period contribute to the problem?

Elementary logic suggests that if the real estate financing sector was weak and fragile, and if monetary policy was gradually being tightened on the short end of the yield curve -- to flatten it as part of a very long-term operating strategy by the Federal Reserve -- then indeed monetary policy "contributed" to the current recession, although it was not the cause of the weak and fragile condition of the real estate financing sector. We understand today the role deposit insurance played in undermining real estate finance, and reform proposals have been introduced to correct those problems for the future.

Of more immediate concern is the question whether monetary policy is now appropriate for economic recovery and growth for the rest of 1991 and thereafter. In this regard there is a significant reason for optimism.

Graph VI.2 -- Interest Rates and Real Economic Growth



Source: CEA

*Projected

Federal Reserve policies to raise or lower interest rates are often discussed in terms of the effect on markets in the next one or two quarters. Legislative and Executive Branch officials call on the Fed to tighten against inflationary pressures or ease before contractionary forces can gain momentum, reflecting the prevailing view that monetary policy changes have the greatest economic effect after a lag of two or three calendar quarters. However, an economic model by David Ranson of H.C. Wainwright Economics in Boston suggests that changes in interest rate policy will have their most powerful consequences far beyond the immediate economic horizon. Indeed, the effect of changes in interest rate levels can be an indicator of real economic activity two and even three years in the future.

Therefore, the steady decline in interest rates from the peak in March 1989 would argue for renewed economic growth in the second half of 1991 and 1992. Moreover, the recent Federal Reserve actions to bring rates down even further will serve a dual function, both making liquidity more available now and signalling a much stronger real growth rate in 1992 and 1993 than would have occurred otherwise. Of course, now that the "flat yield curve strategy" seems to be no longer in operation, we have to be concerned about the effect of recent actions on the longer term inflationary outlook, in 1992 and beyond.

Chapter VII

**BANKING, INTERNATIONAL FINANCE, AND
DOMESTIC GROWTH**

The U.S. banking system is being strained by the increased competitiveness of the newly emerging structure of world commerce. Congress is faced with the difficult job of crafting new banking legislation that allows the United States to compete internationally in financial services and meets the needs of a quickly evolving international trading system. At the same time, it is important to reform, restructure, and recapitalize banking in the United States to ensure robust and orderly domestic economic growth. These twin needs pose a difficult and important challenge to policymakers, the banking industry, and their customers.

An important caveat must be remembered. The government serves the taxpaying citizen, and the banking system serves the same individuals in their roles as consumers and producers; these citizens, rather than institutions, should be the primary focus in the ongoing reconfiguration of the banking system.

Federal deficit spending is once again raging unchecked, and this increases the challenges faced by the economy, the banks and the taxpayer. The soundness of the banking system must withstand the distortion of the capital markets due to the dysfunctional budget policy. The current difficulties in the banking system, combined with the exceptional amount of total debt in the system, have caused an unambiguous "flight to safety" to purchase debt issued by the federal government. This has resulted in an abnormally high rate spread between public and private debt, which lowers the relative cost to the federal government of financing deficits and raises the relative cost of private-sector borrowing.

Beyond curbing deficit spending, additional policies can be instituted to assist our business and banking competitiveness, both at home and abroad. The original purpose of deposit insurance was to protect the small depositor, and that should be the essential goal of any reforms. The overwhelming majority of investors is protected by a \$100,000 limit on deposit insurance. The average account is less than \$10,000, and the average citizen would be protected by the \$100,000 limit even if personal savings rose dramatically. Reducing the \$100,000 limit might provoke undue concern and result in increased pressure on the small but sound banks in the financial system. IRA accounts at insured financial institutions also have \$100,000 of coverage.

Currently, by use of an investment contract, an additional \$100,000 of coverage on a pension fund can be obtained for an individual. Prudent methods of financial management require diversification of retirement assets in large pension plans to insure against losses. Such diversification is standard operating procedure for prudent financial managers and is also required under ERISA. The current coverage of pensions by federal deposit insurance takes the incentive away for prudent diversification of pension savings. The Congress should consider this area carefully as part of its comprehensive restructuring of deposit insurance.

An additional effort that could make a real difference to taxpayers and to the average saver would be early intervention. Regulators need to be alerted to problems in order to stop losses before capital values are destroyed and losses mount. In this effort, coordination of the data about the structure of bank assets along with real world data about the events in the market for similar assets could be helpful in alerting regulatory authorities to potential problems.

Another source of banking information would be created with the advent of a risk-based premium structure for deposit insurance. The same information that is generated to calculate the risk premium would be useful in identifying characteristics of the type and level of risk exhibited by a bank.

In attaining a banking system that will meet the rigors of increased international competition, we need to allow U.S. banks to reach reasonable scales of operation in order to allow them to compete. Therefore, federally chartered banks should be allowed to open branches in any state that will allow them in. At the same time, those banks that reach the scale appropriate for international competition should not have an advantage over other banks because they are "too big to fail."

A recent study by Barth, Brumbaugh, and Litan for the House Banking Committee concluded that for banks that were resolved, that is, merged or taken over, among banks at the same level of capital, "the large banks were less likely to be resolved than small banks during the 1987-89 period."¹

¹ Barth, James R., Brumbaugh, R. Dan, Jr., and Litan, Robert E. The Banking Industry in Turmoil: A report on the Condition of the U.S. Banking Industry and the Bank Insurance Fund, Presented to the Financial Institutions Subcommittee of the House Committee on Banking, Housing and Urban Affairs, December 17, 1990 (Washington: 1990, U.S. Government Printing Office) p.61.

Another problem that may disproportionately affect small banks is the crowding out of private sector activity as a result of the heavy borrowing being conducted by the federal government to finance budget deficits. This problem has been exacerbated by the restraint on growth in the money supply in 1990.

Federal outlays are escalating more rapidly than revenues, and this usurps private credit availability to the full extent needed to cover deficit spending. Credit is in great demand to finance tremendous changes and past mistakes throughout the world. Spending is surging toward, and threatening to go beyond, the post-1947 historical high of 24 percent of gross national product that prompted minor remedial action on spending in 1985. Almost one-fourth of U.S. GNP is going to the federal government at a time when the states and localities need additional revenues, the private sector is short of capital, and the world, perhaps with the exception of Japan, is looking to borrow.

In this atmosphere of uncertainty, the increased preference for federal government debt results in an increase in the rate spread of Treasury bond rates below prevailing rates on private sector bonds of an equal maturity length. Thus, the rate and resulting cost of borrowing to the government is lower than it would otherwise be, an effective subsidy, and the rate to the private sector and state governments is higher than it would normally be, raising the cost of doing business. The collapse of Drexel Burnham Lambert and the junk bond market is an additional factor in the rise of this differential.

As a result of this abnormally high spread, the financing costs of federal government deficits are artificially low, encouraging greater deficit spending. The cost of borrowing money is relatively high, increasing the cost of doing business and decreasing the demand for loans from the banking system. This compounds the difficulties of the banking system as it attempts to restructure and recapitalize to remain competitive in a changing world and domestic economy.

This implicit subsidy to government borrowing is in addition to the favorable spread that results simply because federal debt is backed by the full faith and credit of the federal government including, implicitly, the understanding that the Federal Reserve will prevent any default on federal debt. Additionally, regulations that require idle balances from various federal trust funds be kept in U.S. Government securities creates a captive market for federal securities and, therefore, additional market pressure for a rate spread unfavorable to private sector financial instruments. A preference for U.S. Treasury securities by foreign investors, important forces in the market in recent years, further accentuates this trend.

Rate spreads of debt securities typically show a pronounced pattern over the course of the business cycle. Where 100 basis points are equal to a full one percent increase in an interest rate, the typical spread following a business downturn with a lag will exceed 200 basis points according to recent data.² These spreads at year end were at about 150 basis points, early on in the economic downturn. In 1986, this spread between 10-year U.S. Treasury bonds and corporate issues approached 300 basis points, in part due to perceived risk of extensive leveraged buy-outs at the time. Research by Goldman Sachs concludes that:

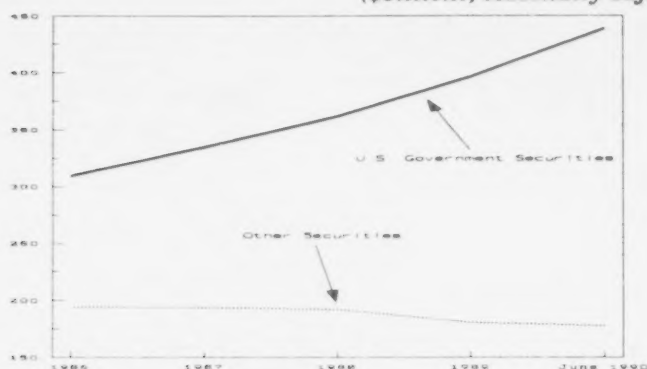
Since 1986, however, the ballooning federal budget deficit has pushed Treasury borrowing up much more than the rise in corporate financing. This is likely to continue throughout 1991 at least.³

In recent years there has been a flight to U.S. government securities in the holdings of banks, significantly ahead of the downturn in the economy. Graph VII.1 plots this replacement of nongovernment securities with government securities. The event is roughly coincident with debate about and final passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). This Act addressed specifically the use of low rated or "junk" securities by savings and loan institutions, but this may have signaled the banks as well to move into investments that could not be criticized. They may also have sold to get out of junk bonds before they lost additional value.

² "The Surprising Course of Yield Spreads," Financial Market Perspectives, Economic Research, Goldman Sachs, January, 1991.

³ Ibid. p.8.

Graph VII.1 -- Securities Held by Banks
(*\$billions, seasonally adjusted*)



Source: Board of Governors of the Federal Reserve System.

Rather than upgrade to more highly rated private sector securities, the banks clearly moved into federal government securities at a time when their return from such securities was historically low relative to top-rated, private-sector commercial paper. This increase in the spread results in part from regulatory uncertainty faced by the market, beyond the normal market uncertainty. As a result of the economic slowdown, rate spreads could widen well beyond the three percentage points characteristic of recent recessions.

Efforts to restrain a relatively low percentage of errant savings and loans and banks have inadvertently made it more difficult to maintain liquidity to the private enterprises that the banks serve. Both the specter of future re-regulation and the pause in economic activity come at a time when our economic system needs to redouble efforts for international competitiveness. Our banks need to simultaneously help finance domestic private sector development and position themselves to compete in the international financial marketplace. It is simply the wrong time for Congress to implement any additional policies that assist deficit spending at an artificially beneficial rate to the federal government.

Deficits crowd out important private sector activity, and in the current environment, are squeezing activity financed by bank loans and by issuance of private-sector commercial paper. The sheer volume of federal debt issued, the normal decline in the volume of private sector debt as economic activity lulls, and the decline in foreign investors, who prefer U.S. Treasury debt issues, could serve to keep the rate spread from widening further.

Any narrowing of spreads would force federal debt payments to an amount more nearly equal to its opportunity cost of foregone private sector activity, thus raising deficits. Any narrowing of rates would result in even more squeezing-out of the private sector activity. If abnormally high rate spreads continue, the taxpayer will only be spared for an illusional short period: in the ensuing years economic growth and the rationalization and strengthening of the banking system will be slowed. Reduction of government command of real resources, and the financial credit that currently supports this command, is the only long term cure for the credit crunch suffered by our consumers, banks, and businesses.

The extent of the flight into safety, or, perhaps, the (regulatory) fright into safety, is hard to reduce to a single measure, but it is unambiguous. The Congressional Budget Office studied the fall in loan activity by banks and the simultaneous investment in U.S. government securities and summarized that "one indication that some slowing in credit came from the supply side is that banks increasingly shifted available funds away from loans and into safe government securities."⁴ As federal spending accelerates, deficits once again threaten domestic and international investment. Combined with a swing to bank regulation that is too stringent, deficits also are lessening our ability to compete internationally for the supply of financial services. There is no "free lunch" for the big spenders in Congress, and the taxpayer, the banker, and the businessperson are paying dearly.

The task for Congress as it addresses a banking policy for international financial competitiveness and national growth might start with a balanced budget that limited spending increases below GNP growth. Budgetary excess was the reason that the Gramm-Rudman legislation was passed in 1985, and it produced outlays in fiscal year 1986-89 that did not usurp a growing share of GNP (see Table VII.1). During this period, real outlays continued to rise, so that the federal government was not cut, but rather increased.⁵

⁴ The Economic and Budget Outlook: Fiscal Years 1992-1996, A report to the Senate and House Committees on the Budget, 1991 Annual Report, Congress of the United States, Congressional Budget Office, January 1991, p.26.

⁵ Source: *Ibid.* p.150.

Table VII.1
Total Federal Outlays to GNP
(recent years)
(constant FY1982 dollars)

Fiscal Year	1985	1986	1987	1988	1989	1990	1991
Total Outlay as a Percentage of GNP	23.9	23.7	22.7	22.3	22.3	23.2	24.7 (est.)

Source: Congressional Budget Office.

The growth rate in FY 1990 of nearly a full percentage point of GNP is well beyond the historical postwar high reached in FY 1983 of 24.3 percent of output. CBO projects 24.7 percent while OMB projects 25.1 percent for FY 1991, and the projected rate moves beyond 25 percent of GNP in less than two years. This represents real resources controlled by the federal government and usurped out of availability for export. Since much of government spending is being financed by deficits, a parallel crowding out occurs in financial markets. This disrupts domestic investment that supports future competitiveness, bank recapitalization, and the provision of financial services. The dire cost of big spending is felt in real export and financial markets.

The challenge to policymakers is to remake a banking environment in which the largest banks are free to compete in the international market, and the smaller banks are allowed to compete domestically. One of the most important elements to achieve this is to keep escalating federal spending and debt out of the way of growth. The small saver and the taxpayer must not be billed for every management and regulatory mistake in the essential reform, restructuring and recapitalization of our financial system.

Chapter VIII

**INTERNATIONAL ECONOMICS --
AT THE CROSSROADS**

The Current Outlook

The United States made significant gains in increasing exports last year, as the export sector benefitted from the softening domestic economy. Exports in 1990 ran at an annual level about \$30 billion ahead of 1989. Although imports increased, the trade balance improved by \$8 billion in 1990 compared with 1989. Continued moderation of oil prices will further improve the trade balance.

1990 began with a burst of optimism for future expansion of the world economy. As 1991 unfolds, some uncertainty clouds the picture, but the long-term prospects remain healthy. The Middle East war, the instability in the central government in the USSR, and the lull in economic activity all have short-term implications for slowing development of market-based international trade; the important task is to prevent these transient problems, as well as the growing political pressure for protectionism around the world, from derailing the move to a truly open world marketplace.

The slow response of some of our major trading partners to the aggression of Saddam Hussein is mirrored by their intransigence in tackling the major problems of the world trading system through a successful conclusion to the Uruguay Round of trade negotiations. World leadership in providing an open and fair trading system falls by default to the United States.

The trading nations of the world need U.S. leadership in order to assure a trading system that provides growth for all nations. A proclivity for leadership in the American character results in a natural reluctance to engage in protectionism. The openness of American society means that actual attempts to protect beleaguered American industries often are inept. Protectionism is simply not something in which America's people or its economic system has a comparative advantage.

Those who ignore the moral imperative for the United States to foster an open and fair world trading system are likely to come to equivalent

conclusions through pragmatism about the failure of protectionism. Protectionism begets a fall in the volume of trade, and thus the losses for all grossly outweigh any gains by a small number of countries. What meager relative gains are to be had from protectionism are unlikely to be captured by the United States. As a large exporter as well as a large domestic producer, the United States stands to suffer a disproportionately large share of the loss of world output from escalating protectionist policies.

Additionally, the U.S. market with a GNP of \$5.5 trillion will always be a magnet for fair and unfair world traders. An unfortunate asymmetry exists in the costs of learning one language and set of regulations to enter the U.S. market compared to the high multiple of those costs for Americans to enter an equally large collection of economies. There is a rational economic explanation rather than a character defect to explain why efforts of U.S. producers abroad are not relatively greater than those of traders wishing to enter the U.S. market. Unfair barriers to market entry can significantly increase this cost asymmetry. Unfair practices, when not policed by an international agreement, add to the difficult task of increasing U.S. exports.

***The General Agreement on Tariffs and Trade (GATT),
the Uruguay Round and the Future of the Trading System***

The GATT, inclusive of the current negotiations of the Uruguay Round, represents the potential consensus that can be achieved in international trade among the 100 signatories of the agreement. The GATT will surely continue to be the basis for international trade for years to come.

The GATT came into existence in 1947 and became the basic foundation of global trade expansion. It was expected to be superseded by a more comprehensive subsequent agreement. The Uruguay Round is the latest evidence of the evolution of the GATT. The GATT could, however, be the basis of trade for the next decade for any softness in growth for the major trading powers makes a comprehensive change in the trade agreement less likely and the expected operational life of the existing GATT longer. While there are significant shortcomings of the existing GATT, it is absolutely essential to focus on accomplishing as much as is possible within its framework.

Pivotal to continued expansion of U.S. exports in coming years is the utilization and improvement of those parts of the GATT that are working or could work effectively. The Uruguay Round, the eighth round of multilateral trade negotiations under the aegis of the GATT, provides an opportunity for enhancing the effectiveness and credibility of the GATT. Increasing evidence that the world economic growth is slowing somewhat makes it more important

that progress made in the Uruguay Round be formally concluded. This will help insure the continued expansion of U.S. exports.

The most important elements of this latest round of trade talks include four broad categories: greater market access for U.S. exports of goods and services; rules governing trade in areas not currently covered, including services, intellectual property rights and foreign investment; reform of agricultural trade, and an effective dispute settlement process.

Of these four topics, agricultural trade has proved the most vexing to the United States, and intransigence and indifference on the part of many of the GATT participants, particularly the EC, has resulted in a near failure of the Uruguay Round.

The first three topics are of such immense interest in the United States that the dispute settlement mechanism has not received much attention. In total, the talks cover 15 negotiating groups, including a broad look at the functioning of the GATT System (FOGS), which looks to increase GATT surveillance of trade policies of members, improve decision-making of the GATT, and strengthen the relationship of the GATT with other international organizations such as the World Bank and IMF. These efforts to improve the GATT are necessary to make the GATT workable for the foreseeable future, and yet have tended to be overlooked in the concern over agricultural trade, services trade, and protection of intellectual property.

For the longer term outlook, the FOGS group also is considering a proposal for a World Trade Organization (WTO) to supersede and incorporate the GATT, much like the WTO that was developed and presented but not ratified by the U.S. Senate in 1947. The practical point is that in the current period of sluggish world economic growth, a failure of the Uruguay Round is unlikely to be followed by any agreement that is more sympathetic than GATT to U.S. interests or growing world trade.

For some time, GATT nations have been near an agreement to strengthen the dispute settlement mechanism as it deals with the right to a panel proceeding, a reduction in the ability of a country to block a complaint, and a binding and swift appeal process. These changes would allow a greater range of trade difficulties to be settled under the GATT mechanism, and provide greater transparency and less variance and uncertainty in the settlement process. This would promote greater adherence to GATT rules.

The United States has expressed the desire for an improved GATT Dispute Settlements Mechanism, and, at the same time, is one of the leading countries in the application of bilateral approaches to trade dispute

settlement. Unfortunately, much of the rest of the world has been quick to develop protectionist tactics. Many of these countries feature a form of "business/government cooperation" that is not constrained by the niceties of U.S. due process procedures.

For example, Korea learned quickly about the U.S. approach to dumping and countervailing duty procedures by sending visitors to make lengthy studies of the U.S. International Trade Commission (USITC), and has since created a dumping procedure styled, in large part, after that of the United States. This, in conjunction with a unique, more complete form of business/government cooperation, is an additional deterrent to open trade as a part of a well-publicized, anti-import program.

In the most developed countries, the Japanese *keiretsu* industrial groups demonstrate a subtle, finely woven business, finance, and government tapestry that makes consistent discrimination against U.S. imports a part of the fabric of Japanese life. The developments of "Europe 1992" have not fully taken shape, but can be clearly expected to provide subtle barriers to American goods. Clearly, these challenges require U.S. planning on a multi-lateral basis. The GATT, with the successful conclusion of the Uruguay Round, could provide the basic frame of support for U.S. strategy.

Escalating protectionism threatens U.S. export expansion, and requires that the United States exercise mature leadership in its role as a primary steward of the international trading system under the GATT. To do less invites disaster for narrowly defined U.S. interests as well as the international trading system. As a practical matter, the open U.S. society, even when rightfully indignant about trade restrictions, stands to bear the greatest burden of losses resulting from trade disputes and diminished volume of international trade.

The interests of U.S. producers or consumers are not served by increased trade restrictiveness. The United States is simply less agile at such a process because of the democratic nature of its institutions. This should be recognized as a long-term strength of our country, not as an unfortunate disadvantage, but it clearly points to the hard-headed rationality of our important leadership efforts toward attaining less restrictiveness among world trading partners.

Under the stress of a worldwide slowdown, any unravelling of the existing GATT system is unlikely to result in a new, superior system. Rather, it is likely to result in serious diminution of the steady growth in U.S. exports experienced over recent years. Thus, support of enhanced effectiveness and transparency of dispute settlement is the best strategy to further U.S. near-

term interests and to set the stage for a comprehensive agreement in the future.

Free Trade Areas and U.S. Exports

Free trade areas represent a smaller scale experiment for more comprehensive trade agreements. They are important to increasing regional trade, but also have a great potential as precursors of future amendments to the GATT or its successors. Although the potential for abuse of the trading system by large trading blocs has been widely discussed, particularly with respect to Europe in 1992, the knowledge derived from innovations in trading agreements will be instrumental to the future of world trade and U.S. exports.

The conclusion of the free trade agreement with Canada, the expected free trade arrangement with Mexico, and the fuller integration of Europe by 1992, herald an increase in intra-hemispheric trade. Intra-European Communities (EC) trade was about \$680 billion in 1989, compared with and intra-Americas' trade of about \$275 billion. The latter number is small, in part, because the large amount of interstate trade in the United States market, but it suggests that trade between the countries of the Americas has a good deal more growth potential than that of the EC. Intra-Asia/Pacific trade, at about \$315 billion, has additional potential for growth simply because many of the countries involved are at a lesser state of development and are growing more rapidly than the countries of the EC.

Such high growth potential exists for many of the countries of the Americas, once problems of excessive debt are overcome. Intra-continental and intra-hemispheric trade can be conducted under agreements that are more far reaching, simply because fewer difficulties exist when reaching agreements with less diverse, smaller group of countries. The emergence of trading agreements among geographically close countries with cultural similarities can be expected simply because such agreements are the most easily reached.

The successful conclusion of the U.S.-Canada Free Trade Agreement (FTA) has spurred interest in broader agreements with the United States and among the nations of Latin America. The Administration's proposed North American Free Trade Agreement (NAFTA), and Enterprise for the Americas initiative confirm this trend and are in our national interest.

***The U.S.-Canada Free Trade Agreement
and Future Agreements***

While bilateral and multilateral trade agreements offer the chance to test more complex and complete trading arrangements, they may also exacerbate existing trade problems. This is true of the agreement between the United States and Canada signed into law in December, 1988.

The appropriate approach to the U.S.-Canada FTA is to monitor the results closely both in terms of the trade impacts of the agreement and the operation of the dispute settlement apparatus put in place by the agreement. The Department of Commerce has international trade data on-line and is making an effort to find more convenient ways to disseminate that information, such as the use of computer compact disks. Additionally, a similar means must be developed that will allow monitoring of the dispute settlement process on both sides of the border. The participation by the United States and Canadian government research organizations, as well as academic and industry-related research efforts, would be helpful in this learning process.

The U.S.-Canada FTA features much more substantive rules than the GATT on disputes between the two parties. For issues of a multilateral nature, the GATT rules apply. Both forms of dispute settlement involve an investigatory panel and may result in curtailing restrictions on trade on both sides of the border.

For example, the U.S.-Canada FTA Panel recently examined a U.S. International Trade Commission decision on fresh, chilled, or frozen pork from Canada and remanded it to the ITC for the second time. The FTA Panel found that the ITC went beyond the original record and expanded the investigation beyond the scope of its own notice on the case.

The hopeful result of panel review is to provide more transparency, clarity, and thus consistency to the operation of the trade agreement and trade dispute decision-making on both sides of the border. The free trade agreement calls specifically for consultation with both Houses of Congress on the selection of panel candidates. These Minority Views express the belief that the free trade agreement and the dispute settlement process should be monitored closely over the coming years in order assure that the implementation of the agreement meets with expectations, and that the dispute settlement process is becoming more efficient and understandable to U.S. and Canadian producers.

The Canadians were concerned about more secure access to the U.S. market, and the agreement and binational resolution of disputes provides

assurances in that regard. The U.S. producers want a reduction or end to Canadian subsidies. Export subsidies will be eliminated under the plan, but the record remains to be established over the coming years on production subsidies. The binational panel provides a process that both sides should be able to trust.

Other U.S. concerns mirror closely U.S. interests in the Uruguay Round, including elimination of tariffs and non-tariff barriers to trade, fair treatment of agricultural trade, an open investment environment in Canada, increased trade in services, and protection of intellectual property.

Immediately, the operation of the U.S.-Canada FTA provides input into the appropriate design of an FTA with Mexico. For the future, such monitoring of both the changes in trade patterns and volumes, as well as changes in the administration of the trading relationship, will be useful to protecting U.S. interests in future agreements in the Americas, as well as help structure the replacement or supplementation of the GATT.

Free Trade Areas and Agricultural Trade

Agricultural trade remains, for nearly every country, one of the most politically sensitive areas and one which poses the most difficulty in negotiation and implementation of free trade areas. Agriculture is the single issue which threatens the successful conclusion of the Uruguay Round of the GATT. Similarly, it has provided formidable obstacles to the free trade agreement between Canada and the United States.

The U.S.-Canada FTA tackles these difficult problems between two of the most productive agricultural producers in the world. Both countries have extensive domestic programs for a wide array of agricultural products, and some problems have not come to a full resolution prior to the institution of the agreement.

The handling of agricultural trade in this agreement will be extremely important to future success of additional free trade agreements, as well as successful agricultural trade negotiation under the GATT. The outcome of these discussions between Canada and the United States will also be critical to trade frictions among the Cairns Group. This includes Canada, the United States, and many of the countries that came to be significant producers in international agriculture as a result of excessive, supported prices for commodities over the last decades. The FTA, as an incubator of workable ideas in agriculture, should receive the serious, concerted effort that its potential suggests.

The implementation process of the FTA is as important to U.S. agricultural interests as the initial negotiating process. Indeed, it would be important to the ongoing improvement of agricultural trade relations if the Canada-United States International Trade Commission (USITC) emphasized agricultural trade in the implementation, continued development, and elaboration of the FTA.

Agricultural topics of importance include U.S. as well as Canadian concerns about market access, Canadian transport subsidies, non-tariff barriers to agricultural trade, an orderly approach to potato trade, and the pricing policy of the Canadian Wheat Board.

Free Trade Agreements with Mexico and the Americas

Free trade agreements, such as the NAFTA, are likely to encourage production processes that stretch across borders. Canada and Mexico have been the main reason for a 60 percent increase in shared production imports in the United States between 1986 and 1989. According to an USITC annual report on production sharing, these two countries make up 52 percent of all shared-production imports brought into the United States. This is ample indication that geography still plays a significant role in the patterns of international trade and that economic integration is ongoing among the economies of North America.

U.S. merchandise exports to Canada, on average, have been double those to Japan in recent years and average 80 to 90 percent of those to Western Europe. Trade with Mexico is increasingly important even without benefit of a free trade agreement. U.S. exports to Mexico increased by 21 percent in 1989 over the previous year, the latest years for which complete data are available. This data represents a period during which Mexico liberalized its trading system, reduced its budget deficit, and privatized many government-owned enterprises. In July 1989 Mexico reached a preliminary debt agreement with commercial banks. These difficult but important adjustments have prepared Mexico for economic growth and make it a trading partner with significant growth potential.

Mexico is an example of the new desire of many countries in the Americas to compete effectively in the world marketplace. Many examples of other country's efforts abound in Central and South America. The recent "Enterprise for the Americas" initiative, as well as visits to the countries by the President and Vice President, recognize the special relationship as well as the potential that the United States shares with these countries.

What remains is to consider sensible additional trade agreements, a course of action in which the countries of South America have shown great

interest. Indeed, it is a heartening sign that eight of the professional staff of the Council of Economic Advisors to the President, well over 40 percent of the staff, list international trade or international economics in their title in 1990, as compared to three Council staff in January 1980. The subject of free trade areas, both in design and in implementation, needs to be studied with respect to immediate and long-term impacts.

A recent study of the proposed U.S.-Mexico FTA suggests both the speed at which integration of these economies has already progressed and also the need to investigate the long-term implications of open trade. The study by the USITC summarized the possible impact on the U.S. economy:⁶

An FTA would benefit the U.S. economy overall, but for two major reasons the benefits relative to the size of the U.S. economy are likely to be small in the near to medium term. First, in spite of Mexico's population of some 88 million, as discussed above its economy is much smaller than the U.S. economy. Second, with a few exceptions, both countries already have low tariff and nontariff barriers to trade with each other. A sizable share of U.S. imports from Mexico already enters the United States either free of duty unconditionally, under the Generalized System of Preferences (GSP), or at substantially reduced effective rates under *maquiladora* production-sharing arrangements. Similarly, many U.S. exports to Mexico are afforded duty-free treatment in Mexico under the *maquiladora* program. Since 1985, Mexico has significantly reduced tariffs and the number of products subject to import permits. Mexico has also liberalized the administration of its foreign investment regulations. The relatively low barriers already allow most of the benefits of trade between the two countries to be realized and therefore limit the potential benefits to the United States of an FTA.

Additionally, the USITC suggests that an FTA with Mexico "could have a greater impact on certain U.S. industries and regions than it has on the U.S. economy overall"⁷ and that while the agreement would increase trade related

⁶ The Likely Impact on the United States of a Free Trade Agreement with Mexico, Investigation No. 332-297, USITC publication 2353, February 1991, p.vii.

⁷ ibid. p.viii

activities along the border, "an FTA could hurt other segments of the U.S. border economy."⁸

Agriculture poses significant concerns for an FTA with Mexico.

An FTA is expected to affect significantly the level of U.S. trade with Mexico in agricultural products. Mexico is the second-largest foreign supplier to the U.S. market for these products after Canada, and the third-largest U.S. export market after Japan and the Soviet Union. About 60 percent of the agricultural imports from Mexico enter free of duty. The remainder are dutiable at a trade-weighted average of 7 percent ad valorem. Mexico's trade-weighted duty on U.S. agricultural goods averages 11 percent.⁹

Particular concern was expressed in the areas of fresh and processed fruits and vegetables, grains and oilseeds, fish and fish products, and livestock.

As an indication of the complexity of evolving trade in North America, it is interesting that a list of the likely interests and concerns to Canada in extending a U.S.-Mexico FTA to Canada contains many of the subjects that the United States has an ongoing concern about in the U.S.-Canada FTA, such as autos and auto parts, footwear, textiles, intellectual property rights and the dispute settlement process.¹⁰

At \$24 billion annually, exports to Mexico are growing rapidly, up 22 percent in 1989 compared with 1988. The potential for growth is reflected in the fact this is one-third of U.S. exports to Canada even though Mexico has more than three times the population of Canada. The U.S. trade deficit with Mexico has been narrowing in recent years, to \$3 billion in 1989 or less than 3 percent of the total U.S. trade deficit. Careful attention to the trade problems could help reduce this significantly. This should be an objective in discussions about the NAFTA, but the overriding goal should be an agreement that strengthens the international competitive thrust of the countries of North America. With careful attention to the lingering trade problems, Enterprise for the Americas within a robust international trade mechanism remains a worthy goal.

⁸ *ibid.* p.ix

⁹ *ibid.* p.xi

¹⁰ *ibid.* p.3-2

International Trade in Advanced Technology and Services

The areas in which the United States is clearly a leader in the world are also areas in which the United States continues to have difficulties with many countries. Extending the GATT to cover services has been a source of contention. In high technology trade, the United States also faces extensive difficulties among many of the world's trading nations. Most often this takes the form of protectionism for an industry far less sophisticated than that existing in the United States. Such resistance is understandable, but nonetheless unacceptable to the United States and its businesses and workers. The GATT members must recognize that leadership of the world trading system does not mean capitulation of our self-interest.

In discussing this subject, it is necessary to bring up the case of a country that is clearly competitive with the level achieved by the United States and yet routinely obstructs reasonable and open access to its markets. Both in high technology trade and in allowing competition in services, Japan is protectionist and mercantilist. This is neither understandable nor acceptable, and poses a danger to the future of the trading system. This unfortunate behavior is emulated and exaggerated by others in the trading system. Korea's recent liberalization of its financial markets is shunted by the capital requirements for operating in Korea of \$14 to \$20 million for a foreign company, compared to \$1.5 million in the larger Japanese market. The price for a trading seat on the Korean stock exchange or the structure of commissions has not been announced, adding uncertainty to costs and planning for financial services efforts in Korea. In contrast, Japan has used non-monetary barriers and subtle pressure to prevent the success that U.S. firms enjoy in other areas of the Japanese financial market.

As young Americans fight bravely to protect the oil that fuels the Japanese export machine, the Japanese protection apparatus relentlessly works to keep American high technology goods and U.S.-provided services out of the Japanese market. Particularly vexing are the recent outlandish attempts to discourage U.S. firms providing financial services in Tokyo, and the consistent reluctance to live up to the agreed approach to U.S. computer chips entering the Japanese market. These problems (Structural Impediments Initiative (SII)) indicate why efforts are failing through the SII. Banking and financial services are one of the few areas where the United States is making serious progress in Japanese markets, and obvious efforts to thwart those efforts could not come at a more inauspicious time in trade relations and world history.

The Semiconductor Arrangement represents another problem in U.S.-Japanese trade relations. U.S. market share under the agreement, seen as a

floor in the negotiations, has become a ceiling to the Japanese industry, and U.S. participation remains woefully below that expected level. There simply is no reasonable expectation that the agreement will be fulfilled within the agreed upon timetable. There remains no excuse, other than unenlightened self-interest, for Japan's failure.

Agricultural products are a source of continuing consternation, and another example where Japanese intransigence will simply encourage and prolong Europe's reluctance to move on these issues. Agriculture is the single issue that could be responsible for the failure of the Uruguay Round. The construction industry remains a concern, but recent commitments by Tokyo to substantial public works projects may provide an opportunity for improvement. Patient but firm monitoring needs to be pursued over the next year in all of these critical areas.

The views of the Republican JEC Members firmly support mature U.S. leadership in the GATT as well as in bilateral trade relationships. However, the United States reasonably expects mature cooperation from those nations that can most afford to display maturity. If the Japanese keep the United States from selling financial services, and the Europeans continue their efforts to keep out the Japanese, both will ultimately feel that they can increase protectionism against the United States. This is a short-sighted perspective for Japan or Europe to adopt. Additionally, the expressed intent by the new Socialist government in Ontario to dismantle the U.S.-Canada FTA suggests the need for U.S. maturity in firm but fair implementation of an agreement that creates compromise on both sides. We owe that effort to the future of all the Americas. World trade is truly at a crossroads, and it is in no one's interest to turn away from an open and fair trading system.

Chapter IX

**A NEW WORLD:
ORDER OR DISORDER?**

The international section of last year's Minority Views discussed the revolutionary political and economic changes that took place during the 1980s, and, in particular, the increasing disavowal of communist political ideology and socialist economic development theories by peoples and governments around the world.

The West's celebration of these ideological victories had barely begun, however, when it became clear that many of the emerging democracies faced uncertain futures -- indeed, that some of the democratic revolutions could take many years to consolidate. Moreover, East European, Latin American, and African countries that initially looked to the United States and Germany as economic role models realized that it would be more appropriate to model their economic systems on smaller, more recently developed nations such as Taiwan.

In response to these changing circumstances, American political leaders and policy experts over the past year have begun to speak of a "new world order," in which the United States will have critical interests and responsibilities. A frequently heard view is that the United States is the "first among equals" in a United Nations-based framework for dealing with international tensions. With the chaotic situation in the Soviet Union, the United States has emerged as the preeminent power in the world -- politically, militarily and economically.

The rising economic strength of Japan, the economically united EC, as well as the fast-growing countries of the developing world portend increased competition in international merchandise, service and capital products. But the United States alone can provide the economic and political leadership to help ensure that these democratic and free market movements remain on track. -

Despite pessimistic lamentations about the relative decline of the American economy, U.S. GNP remains more than two and one-half times that of Japan and five times that of Germany. The per capita GNP of Japan and Germany is only three-quarters that of the United States. And American worker productivity is one and one-third to two times that of Japanese

workers. In the 1980s, the growth rate of Germany was half that of the United States, while Japan's was only 0.8 percentage points higher.

Continued American political and cultural influence in the world is as important as our economic strength. The revolutions of the late 1980s were led by individuals who expressed clearly and forcefully their admiration for the American political and economic system and a desire to integrate themselves into the global economy. The contributions of several East European governments to the Persian Gulf war demonstrate their desire to integrate themselves into a new political order as well.

President Bush described his vision of this new world order in the 1991 State of the Union address as one "where diverse nations are drawn together in common cause to achieve the universal aspirations of mankind -- peace and security, freedom and the rule of law." To this we should also add free enterprise, which has proven to be the best method of achieving economic prosperity.

A World of Trading Blocs?

Given the uncertain outcome of the leadership struggle in the Soviet Union and the fate of the Soviet strategic and conventional weaponry, it is too early to declare a definitive end to the Cold War. Beyond the military component of Soviet power, however, the Soviet government has lost much of its political and economic influence. The most significant implication has been the decline of Soviet power in Eastern Europe and the disintegration of the Warsaw Pact as a military tool of the USSR.

With the Soviet Union's inability to maintain its levels of aid, regional orders outside of Europe are challenged as well. In the bipolar nature of the Cold War, countries could align themselves on the basis of political and economic considerations and receive aid and weapons from one side or the other. The decline of Soviet influence is likely to have an impact that reaches beyond Eastern Europe. Along with the success of democracy may come greater instability and uncertainty. On the economic front, economic conflicts that were dulled by security imperatives may reemerge, leading to regional blocs and trade friction. Yet challenges also present opportunities, and the United States has an unparalleled opportunity to promote peace, security, freedom, the rule of law and free markets.

Within the next decade the world may increasingly witness border disputes and modifications and the birth of new nations, as long-oppressed peoples use their growing freedom to press historic political claims. With less

need to align themselves with either the U.S. or the Soviet bloc, many such countries may feel more secure in pursuing their own geopolitical aims. These actions may enhance world freedom and security, as is the case in Eastern Europe, or may jeopardize it, as with Iraq's invasion of Kuwait.

Along with new political demands may come new political and economic alliances. Though it seems that the world has accepted the wisdom of open markets, recent signs point to the possibility of the formation of regional trading blocs, and even smaller coalitions within larger trading blocs. While these free trade blocs promise benefits to the rest of the world and to member countries, they also contain the worrisome possibility of discrimination against non-member countries.

Western Hemisphere

The President's Enterprise for the Americas Initiative, intended to promote cooperation of the economies of the Western hemisphere in an atmosphere of free trade and prosperity, represents a significant step toward ensuring that the Western hemisphere will be able to compete effectively on a global scale. The plan consists of three objectives: 1) to negotiate debt reduction with selected Latin American and Caribbean countries whose official debt to the United States amounts to \$12 billion; 2) to stimulate U.S. private investment in Latin America; and 3) to promote trade liberalization with the ultimate goal of establishing a hemispheric free trade zone. This builds on the policy of debt reduction that is central to the Brady Plan announced in 1989.

The new commitment of virtually all governments in Latin American to economic liberalization and democracy has made regional negotiations for freer trade more meaningful. The U.S.-Canada Free Trade Agreement signed in 1988, and the U.S.-Mexico-Canada Free Trade Agreement currently under negotiation are essential first steps in what will likely be a lengthy but productive process toward hemispheric integration.

Europe

The European Community (EC), which is moving quickly toward free trade within its borders, will significantly influence world trade. A single European market will boost the efficiency of European industry and stimulate greater economic growth across the continent. In addition, the future membership of the East European economies in the EC promises the Community a larger labor force, access to raw materials, and greater efficiencies of scale. It is important to note, however, that much of its impact is already apparent.

Given the discrepancies in income and productivity among the countries of Europe, as well as deeply imbedded historical ties and rivalries, the European Community itself may eventually consist of smaller economic alliances. These may include a West European bloc, a Nordic bloc with the Scandinavian and Baltic states, a central European trading alliance consisting of Austria, Hungary, Czecho-Slovakia and the Yugoslav republics, a southern European alliance, and, in the East, cooperation among Poland and the western republics of the USSR. As long as these smaller economic alliances do not erect their own barriers, this is a development neither the Americas nor Europe should fear.

The effect of EC'92 on the American economy will depend largely on the European Community's fiscal and trade policies, and the EC's willingness to eliminate discriminatory practices. In the absence of strong protectionist measures on the part of Europe, the 325 million increasingly prosperous consumers should make Europe a growing outlet for U.S. exports.

The Pacific Rim

A trade area in the Pacific Rim is less likely than Europe and the Western Hemisphere to emerge over the next decade. The Asian countries favor global trading relationships to a bloc dominated by Japan, and most countries of the Pacific Rim trade extensively with the Western Hemisphere and Europe.

As consumption increases in Japan, Korea, Taiwan, and Singapore, the trade surpluses of these nations are likely to diminish over the next decade. A more decentralized Soviet Union may eventually result in a growing Siberian economy that will participate more fully in the Pacific region, creating even more trading opportunities for the United States, particularly the western states.

Our trade negotiations with the governments of East Asia should continue to emphasize open trade practices in order to allow U.S. exports greater market access.

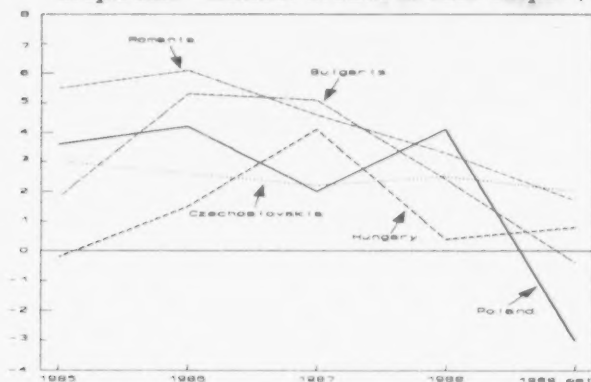
Eastern and Central Europe

Over the past four decades, the United States has devoted vast amounts of resources to safeguard freedom and security in Western Europe. Our contribution has included not only troops and armaments but also extensive economic assistance.

As Soviet influence has declined, U.S. government emphasis has turned to fostering stable, democratic governments and free enterprise throughout

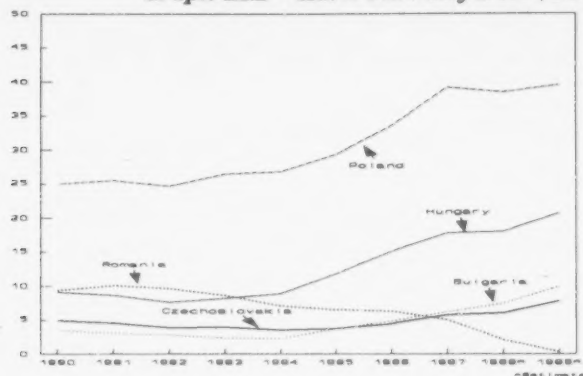
Eastern Europe. This task is made difficult by a Marxist legacy that has left much of the region economically and environmentally devastated, and a populace unaccustomed to private initiative and oftentimes suspicious of government and private actions. The Eastern European economies suffer from slow or negative growth, low standards of living, outdated factories and technology, and massive infrastructure needs. Poland and Hungary are burdened by large hard currency debts.

Graph IX.1 -- Annual Growth in Real Output (% Change)



Source: GAO and Institute for International Finance

Graph IX.2 -- Hard Currency Debt (US \$billions)



Source: U.S. Central Intelligence Agency.

Realizing that economic vitality is essential to the long-term stability of Eastern Europe, many of the governments of Central and Eastern Europe have embarked on intensive economic reform programs that include privatizing state-held firms, encouraging small business development, creating incentives to attract foreign capital, and adopting monetary and fiscal policies to lower deficits and reduce inflation.

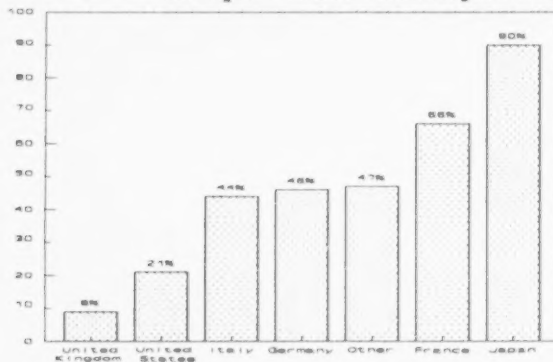
These ambitious programs are encountering some difficulties in implementation. In order to retain public support, for example, the privatization plans must be viewed as fair and should avoid having firms end up in the hands of their old communist managers. A climate conducive to free enterprise and small business development will create alternative employment for the workers who lose their jobs. In the surprising 1990 election in Poland, Poles voted out the Mazowiecki government and many voted for an unknown emigre entrepreneur. Some observers drew the conclusion that the public is likely to reject reform programs that seem to favor the old communist elite and which do not create the immediate wealth-creating opportunities that were the goal of the revolution.

Soviet economic and political instability further complicates the task faced by Eastern Europe's new economies. The Soviet Union has drastically cut its energy deliveries to Eastern Europe, and has begun to charge higher prices in hard currency for oil and gas deliveries that were previously sold at subsidized prices and paid for in rubles or goods. East Europe's energy crisis was exacerbated by higher oil prices arising from the Persian Gulf War and by reduced deliveries and payments by Iraq.

A policy that promotes the creation of democratically elected governments, mutual security and economic liberty and prosperity in Central and Eastern Europe is also likely to enhance American national interests in an area of strategic importance. Such a policy also ensures market access to U.S. firms.

In the past year, Western governments have extended over \$10 billion in aid to Eastern Europe in the form of stabilization loans, grants, credits, in-kind benefits, and technical assistance. The Western economies have also lifted trade controls that were tightened severely in the early 1980s, and this allowed the transfer of modern technology to East European economies. Most of the U.S. aid is in the form of grants, while Japan and many European governments donated more of their aid in the form of export credits and project financing.

Graph IX.3 -- Donor Aid to Poland and Hungary in Export Credits and Project Finance (in %)



Source: GAO and European Community.

Note: Does not include funding for IMF in 1984, and possibly in 1991.

Throughout East Europe's long process of recovery, the reforming governments and supportive Western countries should remember lessons learned from development efforts over the past few decades. Economic recovery is the result first and foremost of appropriate monetary and fiscal policies. Central planning and dependence on multilateral bank loans usually impede economic progress. The U.S. government should emphasize well-coordinated technical economic and management assistance and exchanges, all the while understanding that bureaucrat-to-bureaucrat relations do little to foster a strong private sector. U.S. participation in multilateral lending,

including that of the new European Bank for Reconstruction and Development, should have as its goal facilitating massive privatization and small business development, rather than supporting the public sector.

The United States can also encourage the European Community to eliminate duties of 30-45 percent that are imposed on East European agricultural goods. These duties cause a significant loss of revenue for the new economies in an area in which they have excellent potential to produce high quality, low-cost products. This is particularly important as political instability and economic depression in the Soviet Union continue to decrease its role as an export market for Eastern Europe.

The West must realize that economic progress in Eastern Europe will not come quickly, and that East European economies may be affected by political crises in Yugoslavia, Romania, Bulgaria, Czechoslovakia and perhaps elsewhere.

***The Soviet Disunion: Political and
Economic Instability in the USSR***

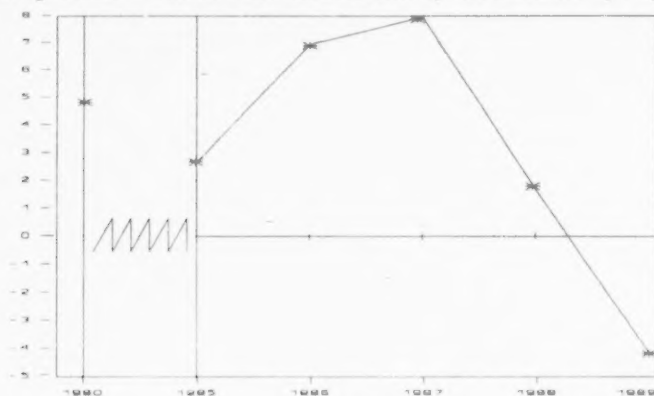
In formulating a policy toward a Soviet Union in disarray, it is important for the United States to comprehend fully recent developments in its society, politics and economy and then take a position on the correct side of unfolding trends.

The current situation in the Soviet Union is the result of years of severe political repression, stifled individual initiative, enormous bureaucracy and vast squandering of labor and raw materials, combined with an attempt to build and maintain a massive military machine and a far-flung empire. Under the surface of what seemed to be a stable system, moreover, was a serious dissatisfaction based on long-suppressed national feelings in republics brought together coercively by Soviet leaders from Lenin and Stalin through Brezhnev.

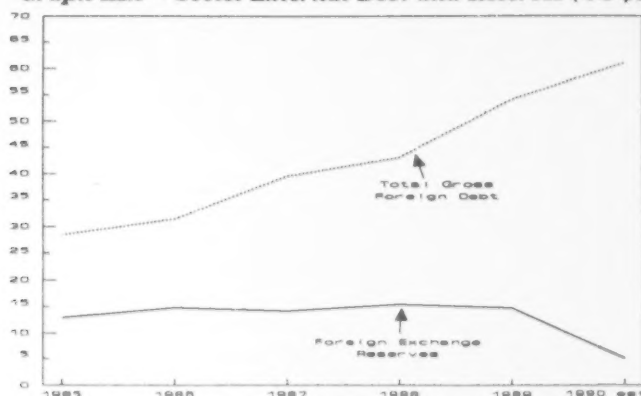
Reacting to economic stagnation, the Soviet state initially eased political and economic restrictions in an attempt to inspire greater individual initiative. Few in President Gorbachev's government realized that "a little democracy" was impossible. Limited reforms only lifted the lid on long-suppressed demands for freedom, independence, and private ownership and enterprise. Economic decentralization inevitably led to political decentralization. As former National Security Agency Director General William Odom testified at a February 1991 congressional hearing: "Power has not drifted into the hands of either liberal or reactionary political factions in Moscow. The real shift in power has been to the republics."

As central control of the Soviet economy diminished, production, distribution and exports fell, and prices, money supply, national debt, and foreign debt skyrocketed. The official distribution system broke down as the black market expanded. Distorted, non-competitive prices led Soviet producers, wholesalers and consumers to hoard goods, and thus shelves of state shops emptied. As the economy worsened, central planners reacted by increasing subsidies on many products. These subsidies led to a growing budget deficit, which was financed by printing money. The value of the ruble plummeted. The Soviet government was forced to increase gold sales in order to earn the hard currency necessary to pay off foreign debts.

Graph IX.4 -- Soviet Current Account of the Balance of Payments



Source: EC, IMF, and Soviet Ministry of Finance

Graph IX.5 -- Soviet External Debt and Reserves (US \$billions)

Source: IMF, BIS, EC, and Vneshekonombank

The pattern of violence, arrests, and enhanced military and KGB influence, as well as severe restrictions on economic activity, that began in the last quarter of 1990 are likely to be the first of many repressive steps in the Communist Party's attempt to preserve its influence in the Soviet Union. The Soviet Union has now entered the stage where the central structure of the state can be maintained only through force, and repression by the Soviet central government could lead to civil war.

Hoping to forestall the impending political and economic chaos, various republics, regions and towns throughout the Soviet Union now controlled by democratic majorities are trying to embark on programs of significant reform. In the absence of constructive reform from Moscow, these democratic leaders are negotiating comprehensive economic and political bilateral treaties between the republics that may serve as the basis for future relationships.

The extraordinary ramifications of the decline of the Soviet Union must be assessed and addressed by the U.S. government and American business. This is a time in history to foresee events and strive to facilitate peaceful change and secure U.S. interests in a strategic area of the world.

When considering whether to give material aid to the Soviet government or provide credits and guarantees to American firms engaged in business with the USSR, it is important to realize that the Soviet Union is not poor, just poorly managed. The problem in the Soviet Union is not one of shortages but of economic policies and attitudes that have destroyed

incentives to produce and distribute. Since the Soviet government has assigned control of the distribution of food aid to the KGB and the military, assistance given directly to the Soviet central government may even be used as a political weapon against democratic sectors.

This fact was confirmed by a report jointly issued in December 1990 by the World Bank, IMF, OECD, and the new European Bank for Reconstruction and Development, which concluded that given the current disarray in the USSR, aid to the central government of the Soviet Union would be wasted.

All foreign aid should have as its aim to create a productive, self-sustaining market economy, not to subsidize a failed, monopolistic government. Instead of supporting the collapsing Soviet state bureaucracy, the U.S. government should begin extending technical advice, economic assistance, and rhetorical support to peaceful democratic groups within the Soviet Union. Only democratic leaders dedicated to freedom and private enterprise will be able to use foreign assistance effectively. President Bush has already begun implementing such a policy by engaging in broader dialogue with reformers in the Soviet Union and targeting humanitarian assistance directly to the Baltic states and victims of Chernobyl in Ukraine.

Private foreign investment would be preferable to foreign aid in those regions of the Soviet Union that have created the most hospitable business environment. This would both reward leaders committed to reform and create incentives for further economic liberalization. It might also provide an opportunity for American companies to establish economic ties with the founding fathers of potentially prosperous republics.

The risks of doing business in the Soviet Union should be assumed by those American firms which have made the decision to become involved in this very unstable region of the world. Soviet external debt is skyrocketing, and many Western banks and firms are now demanding payment on goods and services delivered. Soviet Finance Minister Pavlov has said that "for the moment it is easier to extend a credit than to find the money to repay it." He also revealed that the Soviet government is attempting to delay repayment of more than \$75 billion in hard currency debt, half of it held by Western banks.

This risk should not be transferred to American taxpayers in the form of U.S. government subsidies and credits. Renewal of President Bush's six-month waiver of the Jackson-Vanik Amendment, which tied U.S.-Soviet trade to freedom of emigration, must be considered carefully in light of the Soviet government's reversal in political and economic reforms. Both the extremely

high economic risks in the current Soviet system and human rights considerations should be figured into the decision on renewal.

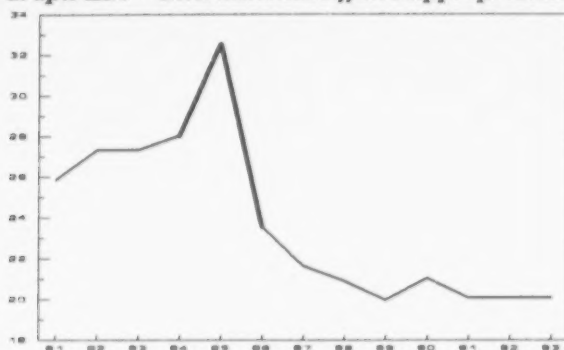
As the situation in the Soviet Union evolves, America can use its enhanced position in the world to encourage peaceful, democratic change and economic liberalization. The United States can also call on its allies around the world to assist its endeavors. Eventually, the Western governments may be able to establish special associations with the Soviet republics, possibly modelled after America's relationship with Taiwan. In the future, they may even be able to extend MFN status to the Baltic States and some of the other economically developed republics in the USSR, as well as membership in GATT, the IMF, World Bank, and the Commission for Security and Cooperation in Europe.

A New Strategy for Foreign Aid

Three decades after it was passed, the Bush Administration and the Congress are attempting to rewrite the Foreign Assistance Act of 1961. The new legislation is intended to incorporate the positive and negative lessons learned from our past experience with foreign aid, as well as new priorities resulting from the new international environment. This will not be an easy task, since the balance of power is still evolving, and the ramifications of the dramatic developments of the past several years may not be fully realized for another decade.

It will be difficult, moreover, to change our priorities in the current budget environment. The level of funding for the international affairs budget has declined in real terms since 1985. The 1990 Omnibus Budget Reconciliation Act placed budget caps on international affairs spending for FY91-FY93 that disallow increases in real terms, but does permit periodic adjustments for inflation, emergency needs and credit reforms. The caps can also be adjusted to fund U.S. quota increases for the IMF and debt forgiveness for selected governments (in 1991, Poland and Egypt). The Budget Enforcement Act also provides a special budget authority allowance, estimated by OMB to be approximately \$950 million for the FY92 international affairs budget. Discretionary spending for FY92 programs may grow 4.3 percent in real terms. The Act makes foreign assistance subject to sequestration. The high cost of the Persian Gulf war exacerbates the complexity of reformulating priorities.

Graph IX.6 -- International Affairs Appropriations, 1981-93



Source: Congressional Research Services, Library of Congress.
 Note: Does not include funding for IMF in 1984, and possibly in 1991.

To overcome partially the problem posed by the budget caps, it is essential that foreign aid legislation be as flexible as possible, permitting the President to deal effectively with emerging international issues and problems that affect U.S. interests. In addition, innovative, more effective and low cost forms of assistance must be adopted.

The record of development assistance over the past 30 years reveals both successes and failures. Some of the historical lessons of U.S. aid efforts, however, have already been incorporated into foreign assistance legislation passed over the past two years. U.S. programs for aid to Eastern Europe and President Bush's Enterprise for the Americas initiative provide examples of the types of development programs that should be emulated in other regions. These programs offer strong support for democracy, free markets and open economies, and emphasize economic growth through privatization, trade, private investment, technical assistance, and debt reduction rather than direct grants of aid to the governments of developing nations.

The following are some of the issues that need to be considered when rewriting the rules on foreign assistance:

Sustained economic growth can only be achieved by policies of recipient nations that encourage individual initiative, free trade, and foreign investment. The United States, therefore, should provide assistance to those countries that are actively seeking

to create an economic environment conducive to private enterprise.

Specifically, such an environment is characterized by guaranteed property rights, a small or at least shrinking state sector, a legal and regulatory structure that facilitates economic activity rather than impedes it, low inflation, the absence of wage and price controls, low taxes, and open trade and investment. Recent aid initiatives have sought to create an **Economic Freedom Index** that provides guidelines for evaluating the economic climate in recipient nations.

Foreign aid shares a trait with many domestic programs: once created, it is rarely eliminated. Governments that implement policies detrimental to growth should not be subsidized indefinitely. Assistance programs should be designed with established **goals, timetables, benchmarks and sunset dates**.

Some of the recipients of U.S. development assistance have "graduated" from the aid program, especially the countries that benefitted from the Marshall Plan. Now that they have achieved prosperity, they should play a larger role in assisting developing nations. The type of **burdensharing** we are seeking in the Persian Gulf today should exist in other types of international activities, including foreign aid.

Since trade is essential to economic prosperity, the Bush Administration has sought to encourage the movement toward **trade liberalization** at the international, regional, and bilateral levels. The Enterprise for the Americas initiative, for example, envisions bilateral trade framework agreements with Latin American and Caribbean nations that include dispute resolution mechanisms; tariff reduction; and, eventually, a hemispheric free trade zone.

Soon after Poland achieved its independence from the Soviet Union, Lech Walesa announced that Poland would not only open the door to private investment, it would take the door off the hinges. The democratic leaders of Eastern Europe seem to understand the value of foreign private capital. U.S. aid programs should include programs that facilitate American private investment in developing nations. The **Enterprise Funds** for Poland and Hungary were created to channel such private investment into new businesses in those nations, utilizing minimal U.S. government funding as seed money.

Some of the East European governments, in an attempt to entice foreign investment, have offered generous tax holidays to foreign firms. American companies have not been able to benefit from these tax breaks to the same extent as their European counterparts because of U.S. taxation on profits earned abroad. The U.S. government may wish to consider **exempting some foreign source income from taxation** to provide incentives for American investment in developing economies. Any proposal of this sort needs to be balanced with its effect on investment in the United States and more general considerations of fairness in the tax code.

Possibly as valuable as American capital is American know-how. **Technical assistance** in a variety of areas, from management to currency reform to accounting standards, can make the difference in nations long deprived of interaction in the global economy. While U.S. government agencies can provide some of this training, development programs should encourage American accountants, attorneys, farmers, bankers, entrepreneurs, and retired executives to share their expertise and talents with their aspiring counterparts. Many associations, universities, firms, and individuals have eagerly embarked on such missions in Eastern Europe, some on their own and others with U.S. government support. Many East European students and managers also have traveled to the United States for internships and schooling. This same initiative should be encouraged in other parts of the world as well.

Debt reduction, while not a desirable form of assistance because of the large budgetary impact and the precedent it sets, may be the only alternative for some nations with serious debt servicing problems. **Debt-for-equity swaps** that involve private firms and banks are a desirable method of reducing the debt burden of these nations. Debt-for-equity and debt-for-environment swaps are central to the Bush Administration's Americas Initiative.

The record of the multilateral financial institutions has not been a shining one over the past decades, and there is little reason to expect that this pattern will improve. Development bank lending is very large and usually targeted at the state sector, while economic growth depends above all on small business development. Thus, our foreign aid strategy should **expand beyond reliance on multilateral bank lending**.

Whenever possible, **direct aid should be channeled through non-governmental organizations and individuals** on both the American and the recipient sides, wherever they can distribute the assistance more effectively.

In countries where the central government is not a viable recipient of aid, but there exist **republic and local governments, industry groups and unions** that would benefit from U.S. assistance, funds should be channeled directly to them. The 1991 Foreign Assistance Act includes such a provision for aid to Yugoslavia, and the Bush Administration is targeting aid directly to republics in the Soviet Union. In the interest of promoting democracy, peaceful change, and economic reform, as well as providing needed humanitarian assistance, such a policy should be extended.

Economic growth, trade and investment in the developing nations of the world offer many benefits for the United States. Businesses have more export and investment opportunities, which strengthens the U.S. economy. Furthermore, prosperous democratic nations are more likely to be peaceful, cooperative nations, and thus the United States benefits politically as well. Unfortunately, Saddam Hussein's Iraq has shown what can happen when a military dictatorship obtains access to vast economic resources. Supporting the growth of democratic political forces is as important as fostering economic freedom in despotic regimes. All these factors should be taken into account when we begin to consider restructuring the U.S. foreign affairs budget.

Chapter X

**NATIONAL SECURITY AND
THE DEFENSE BUDGET**

The Administration's FY 1992 defense budget request continues the real dollar decline in defense spending that began in 1986. Moreover, the defense share of the gross national product continues to decline. Many suggest that this scaleback should be stopped in light of the Persian Gulf war. However, such measures provide insight only into how much the nation is willing to spend for defense, rather than how much is needed to fulfill defense requirements in the current international environment. Competent government practice dictates that the current defense budget should be set on the basis of the threat from other nations or blocs of nations and the strategy for protecting American interests against those threats.

The Administration's FY 1991 defense budget was assembled before the apparent disintegration and then possible reconstitution of the Soviet threat to Europe. Last summer and fall, Congress attempted to align the FY 1991 defense budget with the rapidly changing international environment. Euphoria over the possible rise of democracy throughout the Warsaw Pact nations was not muted by Iraq's invasion of Kuwait as the Senate began to debate the FY 1991 Defense Authorization Bill. The result was a lower defense budget, characterized by procurement stretch-outs rather than unneeded weapons being terminated and non-essential bases being closed. Now, the FY 1991 defense program is a step back onto the path that took us to a Hollow Army in the 1970s.

The Administration's FY 1992 defense budget request was assembled prior to the outbreak of fighting in the Persian Gulf. The overall dollar levels reflect last fall's budget agreement, and could be justified by the diminished likelihood of a major war in central Europe. However, the current international political and military turbulence makes it imperative that Congress once again re-evaluate the U.S. national security situation and the level of resources allocated to defense. For example, the apparent use of Soviet military force in the Baltic states should be factored into the debate for FY 1992.

For the first time since the beginning of the Cold War, the majority of defense resources is directed at threats outside Europe. The need to constrain the large federal deficit makes it imperative for defense resources

to be cost-effectively realigned with emerging priorities. Such a realignment of resources should be derived through a four-step process:

- Define U.S. strategic interests and priorities;
- Identify threats to U.S. interests;
- Evaluate alternative means of dealing with the threats; and
- Maximize efficient use of resources in addressing threats and achieving strategic objectives.

U.S. Strategic Interests in the Post-Cold War Environment

Last year at this time there were many calls for a Peace Dividend in response to political liberalization in Eastern Europe. While the Warsaw Pact is no longer an immediate threat to the North Atlantic Treaty Organization (NATO), in the Persian Gulf America has been involved in the heaviest fighting since Vietnam. While fighting in Europe has become less likely, the possibility of the U.S. involvement in fighting outside Europe has become a reality.

In both NATO and the multi-national coalition in the Persian Gulf, countries with shared strategic interests have aligned military capability in response to a threat. This ordering of nations has been frequently referred to as mutual defense or collective security, and the United Nations is the ultimate authority for this approach. The United States must be prepared to employ military power to protect American strategic interests by ourselves or with other affected nations, as both Panama and the Gulf war illustrate.

In both Operation Desert Shield and Operation Desert Storm, military action was to protect U.S. strategic interests. In establishing defense budgets in the 1990s, policymakers must consider various types of strategic interests: territorial, cultural-political and economic.

U.S. territorial interests are defined by our national borders, including the sea and space above U.S. territory. The primary U.S. territorial interest may be keeping our borders sealed from attack by both terrorist groups and strategic missiles. At the same time, the likelihood of Latin American countries falling towards communism has been substantially reduced by superpower disengagement.

America's cultural-political ties are numerous and varied, ties that will grow as migration to the United States continues. Our cultural-political

interests include states that have established democratic political institutions, as well as nations tied to our heritage. Eastern and Western Europe, South Korea, Israel, and Latin American continue to have high priority in the determination of defense budget resource needs. World peace is being strengthened as despotic regimes are replaced, and we continue to form new strategic relationships based on shared political and cultural values.

Our economic ties may be even more widespread, spanning all regions of the globe. Trade with Europe, South America, and Japan is important to our economic well-being, as are the sea lines of communication needed to conduct that trade. Sea lines of communication and oil trade with the Persian Gulf are also considered strategic interests because of their importance to the world economy.

A strategic interest affects defense expenditures only when the President is willing to commit American troops to battle in defense of that interest. Much uncertainty about the security of American interests remains because of ever-changing superpower relations and the vacuum outside of Europe resulting from Soviet disengagement. In addition, the direction of the Soviet leadership is increasingly unpredictable while Soviet strategic modernization continues, and the military appears to be gaining prominence in internal affairs.

Understanding 1990s' Threats to U.S. Interests

In the post-Cold War era, the threat to U.S. interests is no longer dominated by the Soviet Union. As noted by William Webster, the Director of the Central Intelligence Agency, events in Eastern Europe have made it impossible for the Soviet Union to launch a surprise attack on Western Europe.¹¹ The new political situation, especially the unification of Germany and the elected government now in place in Poland, has profoundly interrupted the logistical and command links necessary for a surprise attack. The resulting increased "warning time" of a Soviet attack directly translates into reduced requirements for American expenditures to support NATO. The reduction in defense expenditures should be locked-in through mutual security treaties such as the Conventional Forces in Europe (CFE) and Strategic Arms Reduction Treaty (START), if and when negotiations are completed.

¹¹ See, for example, testimony before the Senate Armed Services Committee, January 23, 1990.

The Current Soviet Threat

Prudence requires that any reduction in the defense budget take into account the uncertain Soviet political situation and the vast Soviet arsenal, which includes a huge inventory of strategic weapons. Recent Soviet belligerence in the START and CFE negotiations is disconcerting. For example, the Soviets are reported to have moved many forces out of Central Europe in an attempt to circumvent the CFE Treaty. Moreover, Soviet military modernization continues. Whereas the United States spends about a quarter of its defense budget on weapons procurement, the USSR continues to spend about half of its defense budget on procurement. Soviet weapons production in 1989 included 7,400 tanks and armored fighting vehicles, 75 ships and submarines, and 1035 tactical aircraft.¹² More important, Soviet strategic modernization is guaranteed by that country's conviction that nuclear weapons are a key superpower status symbol. The Soviet Union continues to invest large sums in survivability, command infrastructure, new intercontinental ballistic missiles, and cruise missiles. In 1990, the Soviet nuclear arsenal reached a new peak of over 10,000 strategic offensive warheads.¹³

Non-Soviet Threats and the Rise of the Global Arms Industry

U.S. interests are increasingly threatened in regions of the globe which had been stabilized by the bipolar nature of the Cold War. Over the past year, euphoria with the spread of democracy has given way to concerns about territorial and ethnic activism. The most visible concerns are threats to Western economic interests in the Persian Gulf. Ultimately, such activity may affect American territorial, economic, and cultural interests around the globe. In addition, proliferation of military and militarily-useful technology to aggressive Third World leaders is the key factor driving the non-Soviet threat environment.

The events in the Persian Gulf provide important lessons about the impact of arms proliferation in the Third World. The global arms industry is growing exponentially; consequently, other Saddam Husseins may well appear in the 1990s. With considerably less defense expenditure than the superpowers, Hussein has shown that it is possible for a dictator to become a regional military power. Saddam's actions illustrate the proclivity of authoritarian regimes to settle differences with tanks and to correct economic disagreements by stealing a neighbors' possessions -- even traffic and street

¹² Soviet Military Power, Office of the Secretary of Defense, September 1990, p. 38.

¹³ *Ibid.*, p. 70.

lights. It also illustrates that tens of billions of dollars in defense expenditures may be required to respond to such despots.

Tracking global arms sales is difficult because of limited control over international arms trade and the increasing applicability of civilian technologies to military purposes. However, it has been reported recently that major weapons are sold by several countries and more than 24 countries export munitions and support equipment.¹⁴ Moreover, chemical weapons are proliferating rapidly, and these are closely followed by production capability for ballistic missiles. It is now known that over 20 countries are seeking chemical weapons, and it is estimated that at least 15 countries will be able to produce ballistic missiles by the year 2000.¹⁵ In the area of conventional weapons, many countries now sell weapons platforms (artillery, tanks and armored fighting vehicles, and aircraft) as a means to develop demand sufficient to achieve economies of scale and to become self-sufficient in defense.

The United States must now be prepared for a new type of contingency -- regional mini-wars of attrition that may be called "Attrition Conflicts." The key determinant of an Attrition Conflict, as we learned in the Mid-East crisis, is the direct involvement of many U.S. soldiers sent to fight far from American soil. In an Attrition Conflict, the President must be able to respond with forces other than a Rapid Deployment unit meant to free hostages or a heavy division meant to fight the Soviets in Europe. While the United States cannot afford to be the world's policeman, the rise of the global arms industry and potential instability resulting from Soviet disengagement will enable belligerent regional powers to pose a significant threat to American interests.

Relying only on the military response of the United States to the situation in the Persian Gulf can give many a false sense of security. The speedy dispatch of rapid deployment forces and the near simultaneous appearance of a number of Navy ships, including three aircraft carriers, deterred Saddam Hussein from advancing on the oil fields of Saudi Arabia. In addition, the forces of the United States and its allies have routed the Iraqi forces from Kuwait. Yet, neither the commotion caused by one Third World dictator nor the breadth of U.S. military forces responding to the crisis fits the two contingencies (a big war with the Soviets and rapid displays of limited force) currently funded in the defense budget. The most important lesson to

¹⁴ U.S. Arms Control and Disarmament Agency, World Military Expenditures and Arms Transfers 1989, October 1990, p. 25.

¹⁵ *Ibid.*, p. 21.

be learned is that the United States must be prepared for a third, intermediate contingency involving a regional bully.

Alternative Means of Responding to Threats

There are four chief means of dealing with threats to American strategic interests. First, we can enter into mutually verifiable treaties with countries that are potential threats, thereby replacing security derived from defense expenditures with security of a mutual agreement. Second, we can undertake military action, thereby using military power to protect our interests. Third, we can apply unilateral or multilateral controls, thereby exerting economic pressure against countries that threaten our interests. A fourth approach is to encourage threatening nations to become our partners in trade and development. Only the first three means are available in dealing with nations which are aggressively antagonistic to our interests.

Treaties

During the course of the Cold War, the United States and the Soviet Union agreed to several treaties, minimizing expenditures by both sides on certain types of strategic weapons. However, this often led to large investments in alternative weapons. In addition, the Soviet Union has admitted to a violation of the Anti-Ballistic Missile Treaty. It is now widely accepted that treaties must be verifiable and enforceable if they are to be successful. Ultimately, verifiable treaties offer great opportunities to reduce defense expenditures. For example, the Congressional Budget Office estimated that annual savings from the CFE Treaty could range from \$9 billion to \$80 billion.¹⁶

Police Actions/Show of Force

Over the past 16 months, the Department of Defense has twice engaged in fighting in order to protect American interests. In some interpretations of the "New World Order," the United States would be called upon to act as the world's policeman. While such interpretations would be unaffordable, there will continue to be a need for strong U.S. military capability to protect our strategic interests. The Cold War strategies of deterrence, preparation to win if deterrence fails, and flexible response still appear to be valid across all possible contingencies in the 1990s.

¹⁶ See, for example, testimony of Robert D. Reischauer before the House Armed Services Committee, February 27, 1990.

One of the major problems that remains is that the Defense Department lacks the capability for swiftly getting troops, needed equipment, and supplies to conflict zones swiftly -- the problem that defense analysts call "strategic lift." For example, despite the rapid deployment of the 82nd Airborne, the Iraqi army, supplemented by years of desert war experience and modern Soviet tank technology, would have moved relatively easily into Saudi territory long before our heavy forces showed up to fight. The Army's 24th Mechanized Division, the most credible ground force for desert warfare, arrived in Saudi Arabia more than a month after the Iraqi threat was firmly planted in Kuwait; and the 24th Division was not fully operational for several more weeks. Yet, deploying just the 24th Mechanized Division required all of our "fast" sealift ships.

Unilateral Sanctions & Multilateral Controls

Perhaps the major underlying issue is whether the U.S. government can unilaterally control the flow of weapons technology to developing countries. Since many technologies (e.g., mini-computers) have multiple uses, including military, it is very difficult to restrict military-relevant goods without also restricting American companies' ability to compete in the global marketplace. In addition, since the United States is only one of many countries selling such dual-use technology, a country can purchase an item from several countries. The country may even purchase an item from a country that originally purchased the item from the United States, so we are inadvertently a second-hand source.

There are many technology-specific multi-lateral control regimes, such as the Missile Technology Control Regime. These regimes had some success in restricting the flow of technology to the Warsaw Pact until the Coordinating Committee for Multilateral Export Controls (CoCom) lifted trade restrictions last summer. One contemporary proposal for limiting proliferation of nuclear and ballistic missile technologies is to pursue multi-lateral agreements to restrict certain technologies. However, for many dual use items, it will be impossible to obtain agreement on restricting trade. Moreover, data gathering, verification, and enforcement must be added to current approaches in order to effectively restrict the flow of military technology to Third World aggressors.

In January, the Republican staff of the Joint Economic Committee completed a quantitative study of the value of sanctions.¹⁷ The study evaluated over 100 sanctions employed since World War I. The primary

¹⁷ "The Value of Sanctions Against Iraq: An Assessment of Available Data," Congress of the United States, Joint Economic Committee Republican Staff Analysis, January 10, 1991.

finding was that sanctions are not likely to work if the goal is to force a country's government to make a major policy change, even if the sanctions create economic hardships. In addition, the statistical results support the finding that sanctions are becoming less likely to be effective over time. The major result is that sanctions must have a large economic impact relative to the desired change in policy if they are to be effective.

Security Through Shared Trade Partnerships

Trade partnerships can become an important framework for developing collective security arrangements in the 1990s. Countries engage in collective security arrangements in order to protect strategic interests including economic interests. Trade partnerships could become particularly useful as a national security instrument if the United States can generate common economic interests. In this scenario, a potential adversary would be deterred from threatening a U.S. economic interest, because of the economic effects to its own economy. An example of this can be seen in our relationship with Saudi Arabia. Now, with the end of the Gulf War and the liberalization of Eastern Europe, there are extensive opportunities for trade partnerships that would yield shared strategic interests and collective security agreements.

Efficiently Spending Defense Resources: Recommendations

Blindly throwing money at public policy problems does not work. Instead of nursing defense programs directed against the old Warsaw Pact threat, the defense budget must be restructured to reflect current international conditions and trends. It is in America's interest for Congress to fund programs that efficiently address the full range of contingencies that are expected to dominate our defense needs in the 1990s.

The realities of the current budget constraints and the risks of the emerging international environment have created a major affordability problem for national security. While events in Europe enable reduction in the size of the force structure, investments must continue to address modernization, sustainability, and readiness needs. In addition, further adjustments in force structure may be needed in response to emerging threats. General Colin Powell, the Chairman of the Joint Chiefs of Staff, has developed what is perhaps the most significant realignment of forces since the late 1940s.¹⁸

¹⁸ See, for example, General Powell's testimony before the House Armed Services Committee, February 7, 1991.

We cannot continue to invest in weapon systems that are too heavy to deploy when needed, or too expensive to purchase in quantities sufficient to fulfill mission requirements. Taking Operation Desert Storm as an example, the war could have consumed a significant portion of 1980's purchases of highly effective guided weapons. Stockpiles of conventional versions or special variants of several weapons (including the Patriot Missile, Conventional Tomahawk Cruise Missile, and HARM anti-radiation missile stocks) were drawn down significantly.

While the value of many guided weapons was proven by the low number of casualties, we must be cautious of budget games played in defense investment decisions. For example, the Operation Desert Storm and Operation Desert Shield supplemental funding request appears to contain funding for programs which should be considered in the FY 1992 budget request. Further, we should favor such unglamorous items as treaty verification techniques, strategic lift ships, logistics infrastructure, weight reduction, stockpiles, and host nation support for U.S. involvement in contingencies outside Europe. Advances in military technology must continue to be a priority in 1990's defense budgets. This should be coupled with continuous DoD acquisition system reforms that will enable the technology advances to be converted to fighting capability at minimal cost and on schedule.

The rapidly changing world requires that we identify how and where we should invest in order to limit risks to our interests. In evaluating the FY 1992 defense needs, a results-oriented framework incorporating five top-level objectives should be applied:

- Balance resources against **regional contingency needs**, including Europe.
- Focus investments on cost-effective approaches to fulfilling **mission area needs**.
- Efficient and balanced investment across the **four capability areas: force structure, modernization, sustainability, and readiness**.
- Use strategic **alliances** as a means to achieve national security.
- **Cost savings** through cost reduction, acquisition system and other defense management improvements, use of product improvements rather than new system starts, and canceling poorly performing systems.

First, resources should be **balanced across all regional contingencies**. We must acknowledge our interests in each region of the globe, including Europe, and we must acknowledge the threats to our interests. Only then can we begin to establish priorities and balance spending according to our strategic interests. One major question is which U.S. interests can be efficiently served by carrier battle groups? A second issue is how many advanced technology aircraft can we afford to put in those carrier groups, versus forward basing Air Force and Army units in regions of interest. In addition, we must recognize and respond accordingly to the spread of advanced technologies that place at risk U.S. interests. For example, the new proposal for reorienting SDI, referred to as Global Protection Against Limited Strikes (GPALS), should be considered as one response to the proliferation of strategic missiles in the Third World. As the success of the Patriot system in the Gulf war illustrated, the cost-effectiveness of GPALS must be considered in light of its strategic value, in addition to the current criterion of SDI program cost relative to countermeasure costs.

Second, we should fund only those programs and activities that **cost-effectively fulfill mission area needs** across the military services' mission responsibilities. In addressing this objective, Congress should encourage DoD to develop competitive technological approaches in order to reduce the cost and improve the performance of next-generation weapon systems. For example, the funding for Army and Air Force close-air support should be determined on the basis of which service can provide the required capability at least cost. The results of Operation Desert Storm should be particularly useful in evaluating investments in close-air support. In addition, the success of the Combined Arms Doctrine employed in Operation Desert Storm suggests that funding should flow towards cross-service and intra-service synergies, and away from programs that support parochial interests. We must also address the relationship between platforms and weapons investments. During the Cold War, as the costs of aircraft and tanks increased and the Soviets' numerical advantage grew, we relied more and more on smart weapons to achieve the necessary kill ratios.

While smart weapons are vastly better than dumb bombs, funding constraints and high unit costs constrain inventories. Many critics argued that the increased capability was not worth the higher prices for smart weapons. Operation Desert Storm proved that many cost-effectiveness trade-offs were not overly optimistic, and, results in certain mission areas (such as suppression of Iraq's air defense) far surpassed expectations. Additional emphasis, however, must be placed on continued acquisition reforms and technologies that reduce the cost to achieve a mission requirement.

The third major objective is to realign investments across the four pillars of defense capability: **force structure, modernization, sustainability,**

and readiness. Funding for modernization has been emphasized over the past 10 years. In addition, there have been some improvements in readiness. The President's FY 1992 defense budget request reflects the view that a major war in Europe would not break out overnight, therefore the United States does not need as many ready, modern forces as it did two years ago. Rather than just cutting the budget, prudence dictates that funding be shifted to sustainability and out of readiness, modernization, and force structure. But, the change cannot be implemented overnight. For example, personnel cuts should not be distributed across the current force structure, such that each active division becomes weakened and DoD returns to the "hollow army" of the 1970s. Likewise, it would not make sense to spend much on modernizing for the next major war, as some defense analysts suggest, without spending an appropriate amount on readiness, or without funding the strategic lift needed to get the equipment to the battle.

The President's FY 1992 budget request reflects a restructuring of the force structure, especially command alignments, that attempts to address world events. It also shifts modernization expenditures from procurement to research and development, reflecting a change away from buying new systems and towards modifying fielded systems. With respect to readiness, the President's budget reflects a decision to maintain a rapid response ability, a philosophy which has proven important in responding to contingencies such as in Panama and the Persian Gulf.

Perhaps sustainability is the most neglected of the four pillars of defense capability. Developing sufficient stockpiles for a war in Europe was important during the first half of the Cold War. As weapons and spare parts costs have continued to grow more rapidly than the defense budget, stockpiles have grown more slowly. However, the defense industry has been slow to modernize its management and manufacturing techniques, making it an unreliable supplier. A critical consequence of this trend was the demise of the A-12 bomber program, with the result that the utility of the entire Navy carrier fleet has been seriously constrained. In addition, cutbacks in defense purchases have caused tremendous financial stress for many defense contractors. As DoD becomes increasingly reliant on such dual-use technologies, it will be able to benefit from the strength of commercial industry.

The fourth major objective is to **develop and improve regional alliances** by stressing the political influence of U.S. military power, capitalizing on foreign defense investments and infrastructure, entering into burdensharing arrangements, and providing security and economic assistance to protect American interests abroad. This is especially important in light of the growth in the global defense industry and foreign technology developments that have

military applications. The value of this fourth objective can be seen from the fact that our actions in conjunction with NATO is what finally ended the Warsaw Pact Threat. Another example is the multinational alliance operating in the Persian Gulf. As such mutual security arrangements become more prominent in the 1990s, the issue of burdensharing will continue to affect the American defense budget debate. The framework that evolves should emphasize cost-sharing in line with benefits and ability to pay.

The fifth major objective is to pursue **cost savings** by reducing weapon systems life cycle costs, improving Defense management, and pursuing smarter procurement practices. One key goal here should be reducing cost and schedule overruns so that technology advances can be fielded in an efficient, expeditious manner. For example, we should reward cost reduction in the acquisition process and remove the bureaucratic disincentives to saving money. In addition, a substantial portion of the technology base should be devoted to life cycle cost reduction (for example, common seeker algorithms). The failure of DoD's acquisition management reform efforts can be documented by the problems that arose in the Navy's A-12 bomber program. In general, advances in technology should be pursued, but management improvements must continue. Technology advances should be achieved within cost and schedule objectives.

National Security Expenditures in the 1990s

While the defense budget cannot be slashed overnight, a decline is underway. There are significant reductions in military needs that may result from what is perhaps the most significant conventional weapons treaty of our time, the CFE Treaty. Other treaties may not be far behind. The key to reduced force needs in Europe is ensuring verification and enforcement of these treaties.

With the Cold War ebbing, turbulence elsewhere in the world has been increasing and may require some expenditures that were not considered a year ago. Also, the Soviet Union is still modernizing its nuclear arsenal. These uncertainties make any precipitous reduction of the defense budget, as many have proposed, a dangerous response to the end of the Warsaw Pact threat to Western Europe. However, significant savings will result from restructuring the defense budget to reflect 1990's conditions around the globe.

The situation in the Mid-East should not cancel our phased reduction in defense expenditures for three important reasons. First, the costs for our deployment should be largely reimbursed from allies, and with commitments

of over \$50 billion, the Administration is achieving some success in making this happen. A key concern is to obtain actual payment of commitments. Second, there are transfers of funds that can be made within the roughly \$300 billion 1991 defense budget, reflecting the normal shifting of priorities in line with world events. Third, troop and equipment reductions are driven by changes in Europe, thus resources shifted to Operation Desert Storm may not need to be replaced. Of course, the actual use of the defense budget to pay for Operation Desert Storm is constrained by government accounting procedures, and total consumption of defense resources is uncertain at the time of this writing. In addition, a limited supplemental appropriation to pay for Desert Storm seems certain to pass the Congress before Spring.

CONCLUSION

These Minority Views express optimism about America's economic and political future. On the domestic front, the fundamentals of our economy and our system of government remain strong. On the global horizon, the challenges appear greater than one year ago, but the tide toward "free men and free markets" still appears irresistible.

As the introduction to the bipartisan section of the 1990 Joint Economic Committee Report noted,

....the world has shifted toward democracy and free market economies to a degree beyond any expectations. This change offers the hope of peace and prosperity for all nations. It is also a testament to the success of the political and economic systems of the United States....

The Minority section of this Annual Report restates the goal of peace and prosperity for all nations, and faith in the political and economic systems of this country. The theme throughout the Minority Views is to learn from the policy failures and successes of the last 20 years to address the issues facing the nation in the remainder of this century and beyond.

The major lesson which America has learned is to rely on the dynamic creativity of individuals working in free markets and free societies. The process of innovation -- a phrase highlighted in the debate on industrial productivity -- should be our guide. Efforts to protect special interests by resisting the economy's natural evolution are often futile, generally sap the economy's vitality, and always reduce its flexibility and ability to benefit from change. The fundamental goal must be a growing and vibrant economy in the context of stability and representative government.

Monetary policy remains a key factor in strong economic growth. Recent Federal Reserve action toward greater monetary growth is justified. The Fed response could have occurred sooner; if it had, the current downturn would probably be even more shallow. In that regard, the Federal Reserve and other bank regulatory agencies share responsibility for constraining the money supply and contributing to, but not causing, the present economic slowdown. The steady decline in interest rates from the peak in March 1989 indicates renewed economic growth in the second half of 1991 and 1992.

Fiscal policy remains troublesome. The most constructive course is to avoid further mistakes such as counterproductive tax increases. Taxes as a percent of GNP are at historically high levels. Action to lower government taxation of labor and capital would lower the tax penalty on work and investment, boosting the economy. Private savings need to be explicitly encouraged through new tax incentives. A rollback of previously enacted increases in taxes on workers, investors, and savers would help end the recession and provide a stronger basis for new growth.

Real institutional constraints are needed to force Congress to better evaluate new program and spending priorities. Supermajority approval of appropriations measures, discontinuation of baseline concepts, and consideration of provisions to limit taxing, spending, and deficits are among the options. We also call on Congress to implement performance budgeting in government, as the President endorsed in his budget submission.

In domestic policy, government programs envisioning "great societies" have not produced widespread prosperity, free individuals, stable families, or closely knit communities. Policies that rely on and reinforce individual, family, and community responsibility, on the other hand, are proven successes. This Committee is uniquely situated to point out that past bureaucratic, control-oriented domestic policies prevalent in the 1970s ignored many insights made available by public choice economic theory. The mistakes of the 1970s have failed to achieve either sustained economic growth or more equitable resource distribution. Only when these mistaken programs were contained did economic growth revive.

A new perspective on domestic policy will prevent us from repeating past mistakes. The federal government need not withdraw from the domestic policy arena. However, recognizing why past policies failed permits one to build on stronger foundations. Making progress on key domestic concerns -- economic growth, a sustainable environment, quality education, improved health care, and broader worker safety -- may be described as a choice between the failure of the old and the promise of the new.

The successful economic growth policies of the 1980s have had progressive effects on the distribution of family income and federal income tax burdens. Families at all levels have seen income gains of at least 10 percent since 1982, reversing declines in which began in the late 1970s. The income of the lowest fifth of families grew 12.6 percent during the expansion. Changes in the personal income tax over the last 10 years have made the tax burden more progressive. As advocates of tax rate reduction in the early 1980s argued, a cut in high marginal tax rates drew more income into the taxable economy. Persons with the highest tax rates responded to lower rates

by generating more taxable income and tax revenue. However, government spending grew at an even faster rate, so the federal deficit ballooned.

High income Americans responded to the tax incentives after 1981 by generating more taxable income and tax revenues, and their share of the tax burden has increased. Lower marginal rates combined with the real income gains of middle and lower income Americans resulted in lower real tax payments and tax burdens for persons in these income categories. Statistics offer no support for the feeling that the personal income tax burden has shifted from the rich to others. Indeed, the movement has been in the opposite direction. It is true that some lower income taxpayers have seen some increase in taxes. However, the personal income tax law is not the source of this situation. The largest single legislative change leading to regressive taxation for many taxpayers was the signing into law of a major payroll tax hike by President Carter.

The banking system finds itself in difficulty domestically, and at the same time facing a newly emerging structure of world commerce. In legislative reform efforts, it must be remembered that the original purpose of deposit insurance was to protect the small depositor and that should remain its essential goal. The taxpayer cannot be made to pay for management and regulatory mistakes within the banking industry. Congress is faced with the difficult job of crafting new banking legislation that allows the United States to compete internationally in financial services and meets the needs of a quickly evolving international trading system. At the same time it is important to reform, restructure, and recapitalize banking in the United States to ensure robust and orderly domestic economic growth. These twin needs pose a difficult and essential challenge to policymakers, the banking industry, and their customers to form innovative and creative solutions to the problems within the financial sector.

The United States must maintain firm leadership in the GATT as well as in bilateral trade relationships. However, the United States reasonably expects more mature cooperation from those nations that can most afford to display maturity. Japan must allow greater U.S. access to its financial services and markets generally, and the Europeans need to address problems such as agricultural trade. Additionally, there is a need for firm but fair implementation of the U.S.-Canada FTA. World trade is truly at a crossroads, and it is in no nation's interest to turn from an open and fair trading system.

On the international front, the analogy of innovation is equally appropriate. The apparent end of the Cold War affects trade, military, foreign aid and other relations based upon a bipolar world view. A short list of world events -- the emerging European Economic Community, newly-freed

Eastern European nations, Soviet republics struggling for greater independence from Moscow, South Africa emerging from apartheid, Nicaragua enjoying elected government, U.S. free trade agreements with Canada and possibly Mexico, new global environmental concerns -- shows that the international arena is more complicated than ever. The effect of any one of these changes is significant; their simultaneity and interaction result in mind numbing complexity for U.S. international policy.

Although the world may achieve a New World Order at some future point, the short-term reality is a new global dynamism. In such a dynamic environment the United States has many advantages. Its political and economic systems are more flexible than most nations, and thus more likely to be able to adapt to and benefit from changing global circumstances. American economic well being is the envy of many nations and the inspiration for freedom movements around the globe.

The United States' ability to coordinate diplomatic and military resources, as illustrated in the Persian Gulf, is also a major strength. Although our nation cannot afford to and does not desire to be the world's policeman, it has a unique ability to, by example, lead present and emerging democratic nations toward greater international stability through international responsibility.

The proper successor for Cold War bipolarity in the world of the 1990s is the same as the happy replacement for monarchy in the America of the 1780s -- an expanded political order with such a multiplicity of interest that all parties are respected and no one interest dominates. Here James Madison's famous argument in *Federalist 10* about controlling for the inevitable effects of factions within a society is recalled:

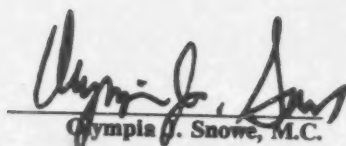
Extend the sphere and you take in a greater variety of parties and interests; you make it less probable that a majority of the whole will have a common motive to invade the rights of other citizens; or if such a common motive exists, it will be more difficult for all who feel it to discover their own strength and act in unison with each other.

The emerging global situation is clearly one that has "a greater variety of parties and interests." In such a world, attempts to return toward bipolarity, to move toward a Pax Americana, or to establish control through international organizations are doomed. As Madison knew, differences of opinion are based in the nature of humanity. Utopias aside, the best that can be achieved is to build mutual respect and interaction whenever possible, and to address violent outbursts wherever they occur.

A flexible and innovative approach to international issues based upon the prerequisite of a growing world economy is necessary. To that end, the United States should seek freer trade among present and potential trading partners, especially the emerging sovereignties in Eastern Europe. It should work to strengthen the economies and political systems of all nations moving toward free markets and political democracy. It should increase and broaden diplomatic ties around the world, and America should help coordinate effective action when diplomatic measures are insufficient to deter aggression. In that regard, recent Bush Administration actions in the new global situation must be commended. We are confident that its flexible and innovative approach will remain successful.

The strength of America is not its government in Washington, D.C., but its people in every state, city, town, and rural area where the American flag flies. Similarly, the strength of the world is not in national governments or international organizations, but in the individuals from every race and nation that covers the face of the globe. The almost infinite variety of individuals and nations means the world will never be assured of harmony. It is possible, however, to limit the number and intensity of conflicts. Domestically and abroad, this nation and its allies should focus on the realistic, achievable goals of strong economic growth, political stability, economic opportunity, and mutual respect for the rule of law and reason as the bases for domestic and international tranquility.

ADDITIONAL VIEWS


Olympia J. Snowe, M.C.

ADDITIONAL VIEWS

Olympia J. Snowe

As I have done in recent years, I am signing the Joint Economic Committee's 1991 Minority Views, but also filing some Additional Views on a number of the topics that are covered in the report. I agree with many portions of the 1991 Minority Views, but would like to elaborate on some of my concerns about its tax and budget proposals, housing and education policies and international trade issues.

Again, in 1991, the JEC's Minority Views comments on the 1986 Tax Reform act. The 1986 Act was a comprehensive measure that phased-in many provisions over the course of several years. The 102nd Congress should continue monitoring the implementation of the 1986 Act very closely to evaluate how it is affecting low-income and middle income taxpayers.

In Chapter V, the Minority Views endorses selling low-income housing units to tenants as part of the larger "empowerment" agenda. I supported this idea, which was included in the National Affordable Housing Act last year. However, the wholesale selling-off of public housing units across the nation is not the final solution to providing access to affordable housing for many low-income citizens. An emphasis needs to be placed on tenant participation in housing management, to ensure that the goals of empowerment do not simply stop with ownership.

As one possible idea for addressing the widespread problem of rising health care costs, the Minority Views suggests that "Health Individual Retirement Accounts" be created. Under this program, the federal government would funnel federal funds to low-income people and allow them to choose their own health care provider.

Giving federal funds directly to private individuals might make more health care professionals available to low-income citizens, but it would take away any systematic checks in our current system whereby the health care system justifies what care is being provided.

Empowerment should be a long-term goal of health care reform. But in the short term, it is important to make every effort to ensure access to health care for all Americans.

Regarding the overall domestic policy agenda for the 102nd Congress, our top priority should be to preserve current employment levels and encourage the creation of more new jobs. Some of the ways that we can achieve this goal are continued efforts to reduce the budget deficit, improve job training programs to provide workers with the skills necessary to meet the needs of businesses into the next century, and protect our domestic industries by requiring fair trade policies with other countries.

Regarding education reform, the Minority Views states, "Clearly, (choice in education) is an area that deserves congressional attention." I strongly believe that education should benefit all members of local communities. Although different kinds of "choice in education" programs have had varied results, there has been no conclusive evidence regarding the effectiveness of these kinds of programs.

Educating our children is of vital importance to the enrichment of their lives and in meeting the challenges of the 21st century. We must continue to work to improve how we educate children through the use of important federal education programs. I will continue to work towards these goals, and hope that the 102nd Congress will take positive action on them promptly.

In Chapter VI, the Minority Views devotes a considerable amount of analysis to international trade and the competitiveness of the United States. In particular, I want to address the role that the federal government must play to help ensure the vitality of our domestic industries, our agricultural base, and our natural resources.

While I share the view that our domestic industries have the strength, ability, and ingenuity to succeed against any other nation in a fair market, today's global economy forces nations to take an active role in ensuring their access to foreign and domestic markets. The American worker is second to none. The ability of our workforce to outproduce that of any other nation's has been consistently proven, but our workers need our support to contend with other governments.

Certainly, U.S. firms must adopt a more aggressive stance against foreign rivals. The growing global marketplace is far more competitive than it has ever been. It also has opened new and exciting opportunities that U.S. firms can take advantage of. However, we must assume that some

international rivals will resort to unfair business practices or subsidies in order to gain a greater share of this market.

Throughout my 12 years in Congress, I have witnessed first-hand the impact of foreign subsidized goods and products upon domestic industries in Maine. In recent months, a shoe manufacturer has announced that it will be moving its operations overseas where manufacturing costs are cheaper. The Commerce Department recently found the government of Norway to be subsidizing its fresh-farmed Atlantic Salmon at a rate of 23.8 percent below "constructed value." These two examples illustrate the need for continued vigilance toward our so-called trading partners.

The 1991 Minority Views denounces the use of trade barriers as a means of providing temporary relief from imports. The United States must differentiate between free, balanced trade and that which is not. The fact is that unfair foreign competition exists and it will not go away by our wishing it to. I believe that trade barriers are sometimes necessary to provide the needed short-term relief for our industries, while also providing a concrete disincentive to those unwilling to play by rules of fairness.

Last fall, along with many other Members of Congress, I vigorously supported legislation to achieve this goal. The Textile, Apparel and Footwear Trade Act sought to limit the growth of foreign textile and cloth imports to one percent a year from 1989 levels, and to freeze non-rubber footwear imports at the 1989 level. This legislation would have addressed the continuing flood of foreign imports into the United States.

Unfortunately, the Textile, Apparel and Footwear Trade Act was vetoed by President Bush and the House narrowly failed to override the veto.

I believed in the importance of this legislation because of my concern with the impact of foreign imports on our domestic textile and shoe industries. These domestic industries have been decimated by the dumping of low cost foreign goods on the market. The State of Maine has been severely affected by plant closings and job losses associated with foreign imports. Since 1980, over 4,400 textile related jobs and 7,000 shoe related jobs have been lost in Maine. This amounts to a 33 and 43 percent decline in employment in each respective industry.

Currently, the trade deficit in textiles, clothing, and shoes account for 26 percent of our total national trade deficit. I believe that the United States must counteract unfair foreign imports which are damaging the ability of American companies to remain competitive and costing U.S workers their jobs. The costs of plant closings, lost jobs, and an increased trade deficit

exceed those of whatever consumer cost increases may occur from limited imports.

The future holds many promising opportunities for U.S. firms. The potential of GATT and a possible U.S.-Mexico free trade agreement can open new doors of opportunity for the United States. However, these same opportunities can become pitfalls if we are not careful in the development of these accords. Our zeal for new trade accords should not lead to the wholesale abandoning of domestic industries.

For this reason, the President's request for a two-year extension of the fast track process for trade agreements should be rejected. The previous and current administrations have shown too little regard for the impact of trade agreements on our domestic industries as our trade negotiators continue their pursuit of free and fair trade goals. I believe these goals can be reached, but with less bloodletting of our industries.

The Minority Views also discuss the need to evaluate the impact of the U.S.-Canada Free Trade Agreement. Although I voted against the Free Trade Agreement, I share the view that this agreement should be studied carefully in the context of learning lessons for future trade agreements.

The dispute resolution process in the U.S.-Canada Free Trade Agreement does appear to work. Last year a dispute panel was convened at the request of the Canadian government to determine if a U.S. law barring the trade in interstate commerce of undersized lobsters constituted an unfair trade practice. The panel determined the U.S. law was not a trade barrier, but encouraged the industry and government officials from both nations to work together to solve the ongoing disputes in the lobster trade between the United States and Canada.

After a series of meetings, a proposal to address the disputed size requirements was drafted for the approval of both governments. This compromise agreement was the result of unprecedented cooperation between the two nations' industry officials.

Unfortunately, the opportunity for cooperation was lost when the Canadian government's Fisheries Minister announced that Canada would not adhere to the cooperative agreement. The U.S. industry has been forced to take unilateral action to address this issue.

This case is important for two reasons. First, it indicates that the dispute process can be effective in addressing the concerns of either nation and that the process can foster cooperation between the nations. However,

this case also indicates that our trading partners will still resist efforts to create free and fair trade in deference to their domestic industries. The United States must remain wary of continued intransigence by our trading partners even after they have agreed to trade reforms.

We are witnessing events which are fundamentally changing our political and economic relationships throughout the globe. The potential economic opportunities for U.S. firms to grow and expand are at their highest level since World War II. Our companies must move forward aggressively and confidently to take advantage of these opportunities. It will be the role of the federal government to foster and encourage U.S. firms in this effort. We must be vigilant against unfair practices and seek new free and fair markets.

The government must take advantage of every tool available and develop new ones when necessary to ensure that our competitive edge is not blunted unfairly. Many positive steps have been taken and we must continue to be realistic and optimistic in our approach to this formidable task. Vigilance must remain the watch word of U.S. trade policy. We owe this effort to our industries and workers.

Finally, in Chapter VII, the Minority Views expresses support for a number of reforms in our current banking laws. These include changing the federal deposit insurance coverage for pension funds, risk-based deposit insurance premiums, and allowing federally chartered banks to open branches in certain states.

Historically, banks have been limited in the type of product they and their holding company affiliates may offer, in order to assure the financial viability of the banking system. Diversifying bank powers and locations could pose greater risks, endangering the financial stability of the country.

I remain very concerned about efforts to allow banks to expand their activities, given their potential effect on the viability of these important industries and federally insured deposits. I also have reservations about how these changes will impact on consumers.

The 102nd Congress must work to ensure a competitive and innovative banking and financial system that provides efficient services to consumers. At the same time, it will continue to be important to regulate and supervise the banking system in order to ensure the safety and soundness of our financial system.

In early February, the Treasury Department released a report calling for a number of changes in current federal banking laws. Because the

banking system is so very important to the health of our overall economy, the 102nd Congress must carefully consider any regulatory and legislative changes in order to encourage a stable financial environment that will allow the economy to resume growing.